

**Issues in Contractor Lease and Rental Costs:**  
**A Critical Analysis of a Little-Understood Cost Category**

**By**

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## I. INTRODUCTION

“Contracting with the United States Government is a unique form of activity dominated by numerous specialized rules. These rules arise out of the nature of the Government as a contracting party and the distinctive forms and procedures used in the contracting process.”<sup>1</sup>

These words open Cibinic & Nash’s treatise on the formation of Government contracts. Every lawyer or practitioner in the field knows quite well that the very nature of contracts with the Government, and the terms they contain, are dramatically different from those encountered in ordinary commercial practice. These differences are commonly expected and accepted, in such diverse ways as the requirements of fiscal laws and obligations of appropriated funds to restrictions on contracting authority. From compliance with assorted social, societal and policy laws, to the wide range of contract types and the costs that will be allowed to be passed through to the Government.<sup>2</sup> Contracting with the Government is a paradigm in itself.

This difference is especially relevant to the instant analysis. The prices of commercial items and services sold to the public consist of their direct costs of manufacture or labor, burdened with a “hidden” share of indirect costs necessarily incurred in doing business and

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<sup>1</sup>John Cibinic, Jr. & Ralph C. Nash, Jr., *Formation of Government Contracts*, p. 1 (2d ed. 1986).

<sup>2</sup>Regulations applicable to contracts with the Government are set forth in the 53 chapters or “Parts” of the Federal Acquisition Regulation (FAR), in Part 48 of the Code of Federal Regulations. In this analysis a regulation such as 48 C.F.R. § 31.205-36 will be cited as FAR 31.205-36.

an added profit margin. However, the prices the Government will pay are subject to a number of political, social and equitable considerations which limit what costs will be allowed. The simple truth is that the Government will pay only what it deems to be "allowable" direct and indirect costs, along with an amount it believes to be a reasonable profit.<sup>3</sup>

"Allowable" costs under the FAR are limited to those that are: (1) reasonable; (2) allocable;<sup>4</sup> (3) consistent with Standards promulgated by the Cost Accounting Standards (CAS) Board, if applicable, or otherwise generally accepted accounting principles (GAAP) and practices; (4) permitted under the terms of the applicable Government contract, and (5) not otherwise limited by the contract cost principles and procedures in Part 31 of the FAR.<sup>5</sup> Unlike commercial contracts where an item's cost is burdened with *all* its associated costs, under Government contracts the only costs permitted to burden a purchased item or service are those that are consistent with the CAS, if applicable, or GAAP, permitted under the terms of the contract, and not otherwise unallowable under FAR Part 31.

One category of costs that a contractor can incur are lease and rental costs for

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<sup>3</sup>See FAR 31.201-1, Composition of total cost and FAR Subpart 15.9.

<sup>4</sup>FAR 31.201-4, Determining allocability, states that a cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. Subject to this, costs are properly allocable to Government contracts if they are either directly incurred in contract performance or indirectly incurred and in the nature of overhead, general and administrative, bid and proposal, or independent research and development costs.

In *Rice v. Martin Marietta Corp.*, 13 F.3d 1563 (Fed. Cir. 1993) at p. 1565, allocation was deemed "an accounting process for accurately ascertaining contract costs." The Court held further that in order for a cost to be allocated to a cost objective (like a Government contract), the cost must have benefitted from, or been caused by, that cost objective.

<sup>5</sup>FAR 31.201-2, Determining allowability.

anything from furniture to light or heavy equipment, to real property such as offices or plants and factories. The ability to determine what lease and rental costs (of whatever nature) that are incurred by Government contractors will under the circumstances be allowable requires that the practitioner have a working familiarity, if not a thorough knowledge, of several different things. Unfortunately it appears that not many practitioners, including Government and contractor officials as well as their respective counsel and accounting staffs, are sufficiently well versed in the subject so as to take full advantage of what it offers. This has resulted in misunderstanding and misuse or abuse, and has undoubtedly resulted in wasted funds.

The misunderstanding seems particularly significant with regard to lease and rental cost allowability. This analysis, therefore, will focus on several issues which frequently arise with respect to that subject. We will critically analyze how the issues can and do affect what costs are allowed, and how the presence or absence of certain facts and circumstances and contract provisions cause the fundamental nature of lease agreements to be completely altered. Along with that change, the costs that are allowed will be dramatically impacted. We will dissect and restructure the elements of the applicable cost principles and their accounting bases to understand their relationships and how they interplay, scrutinizing their underlying policies and theories.

This thorough analysis is necessary for the practitioner to know what costs will be allowable under the applicable circumstances, and why. Once the lawyer or practitioner has worked through the analyses contained herein, he or she hopefully will have gained the understanding necessary to use the various aspects of contractor lease and rental costs to the

advantage of all parties concerned.

## A. SOURCES OF AUTHORITY

As provided in FAR 31.201-2, there are several criteria that lease and rental costs must satisfy in order to be allowable and reimbursable by the Government. Meeting these criteria requires that the costs comply with requirements which have been established by authorities of various different types. These authorities include: (1) cost principles and procedures or policies established for the Government procuring agencies;<sup>6</sup> (2) cost accounting standards which have been "designed to achieve uniformity and consistency in...allocation of costs to contracts with the United States;"<sup>7</sup> (3) accepted accounting principles as have been set out in statements published by the Financial Accounting Standards Board (FASB);<sup>8</sup> and, of course, (4) case law. The interaction of these authorities on the particular facts and circumstances of a specific case, and in particular any pre-existing relationship between a contractor and the owner of property it will use in performance,

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<sup>6</sup>See, e.g., *United States v. Boeing*, 802 F.2d 1390, 1394 (Fed. Cir. 1986).

<sup>7</sup>41 U.S.C. § 422(f)(1) (1988), as cited in *Hercules Inc. v. United States*, 26 Cl.Ct. 662, 665 (1992).

<sup>8</sup>See, e.g., *Denro, Inc. v. United States*, 19 Cl.Ct. 270, 277 (1990).

determine what lease and rental costs will be allowable.

## 1. Cost Principles.

Several cost principles and related provisions in FAR Part 31 contain specific provisions expressly applicable to contractor lease and rental costs.<sup>9</sup> Many of these are addressed in greater detail in the Chapters which follow,<sup>10</sup> but the two that are most significant and of overriding importance to understanding the general category of contractor lease and rental costs allowability under Government contracts are FAR 31.205-11, Depreciation,<sup>11</sup> and FAR 31.205-36, Rental costs.<sup>12</sup>

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<sup>9</sup>Among these are: FAR 31.105, Construction and architect-engineer contracts; FAR 31.109, Advance agreements; FAR 31.205-2, Automatic data processing equipment leasing costs; FAR 31.205-11, Depreciation; FAR 31.205-17, Idle facilities and idle capacity costs; FAR 31.205-24, Maintenance and repair costs; FAR 31.205-35, Relocation costs; FAR 31.205-36, Rental costs; FAR 31.205-42, Termination costs; FAR 31.205-44, Training and education costs; and FAR 31.205-46, Travel costs. Others apply without express reference.

<sup>10</sup>See Chapter V, *infra*, for analyses of some of these other cost principles and the issues they raise.

<sup>11</sup>FAR 31.205-11 discusses depreciation costs generally allowed contractors for their capitalized property. With respect to leases, this cost principle provides, in pertinent part:

(m) 48 CFR 9904.404, Capitalization of Tangible Assets, applies to assets acquired by a "capital lease" as defined in Statement of Financial Accounting Standard No. 13 (FAS-13), Accounting for Leases, issued by the Financial Accounting Standards Board (FASB). Compliance with 48 CFR 9904.404 and FAS-13 requires that such leased assets (capital leases) be treated as purchased assets; i.e., be capitalized and the capitalized value of such assets be distributed over their useful lives as depreciation charges, or over the



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leased life as amortization charges as appropriate. Assets whose leases are classified as capital leases under FAS-13 are subject to the requirements of 31.205-11 while assets acquired under leases classified as operating leases are subject to the requirements on rental costs in 31.205-36. The standards of financial accounting and reporting prescribed by FAS-13 are incorporated into this principle and shall govern its application, except as provided in subparagraphs (1), (2), and (3) below.

(1) Rental costs under a sale and leaseback arrangement shall be allowable up to the amount that would have been allowed had the contractor retained title to the property.

(2) Capital leases, as defined in FAS-13, for all real and personal property, between any related parties are subject to the requirements of this subparagraph 31.205-11(m). If it is determined that the terms of the lease have been significantly affected by the fact that the lessee and lessor are related, depreciation charges shall not be allowed in excess of those which would have occurred if the lease contained terms consistent with those found in a lease between unrelated parties.

(3) Assets acquired under leases that the contractor must capitalize under FAS-13 shall not be treated as purchased assets for contract purposes if the leases are covered by 31.205-36(b)(4).

<sup>12</sup>FAR 31.205-36, Rental costs provides:

(a) This subsection is applicable to the cost of renting or leasing real or personal property, except ADPE (see 31.205-2), acquired under "operating leases" as defined in Statement of Financial Accounting Standards No. 13 (FAS-13), Accounting for Leases. Compliance with 31.205-11(m) requires that assets acquired by means of capital leases, as defined in FAS-13, shall be treated as purchased assets; i.e., be capitalized and the capitalized value of such assets be distributed over their useful lives as depreciation charges, or over the lease term as amortization charges, as appropriate (but see subparagraph (b)(4) below).

(b) The following costs are allowable:

(1) Rental costs under operating leases, to the extent that the rates are reasonable at the time of the lease decision, after consideration of (i) rental costs of comparable property, if any; (ii) market conditions in the area; (iii)

together lay out the basic guidelines for allowability of rental and lease costs in general under most Government contracts. They will be analyzed in detail in the chapters which follow, with emphasis on how each cost principle addresses and impacts those issues that frequently arise.

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the type, life expectancy, condition, and value of the property leased; (iv) alternatives available; and (v) other provisions of the agreement.

(2) Rental costs under a sale and leaseback arrangement only up to the amount the contractor would be allowed if the contractor retained title.

(3) Charges in the nature of rent for property between any divisions, subsidiaries, or organization under common control, to the extent that they do not exceed the normal costs of ownership, such as depreciation, taxes, insurance, facilities' capital cost of money, and maintenance (excluding interest or other unallowable costs pursuant to part 31), provided that no part of such costs shall duplicate any other allowed cost. Rental cost of personal property leased from any division, subsidiary, or affiliate of the contractor under common control, that has an established practice of leasing the same or similar property to unaffiliated lessees shall be allowed in accordance with subparagraph (b)(1) above.

(4) Rental costs under leases entered into before March 1, 1970 for the remaining term of the lease (excluding options not exercised before March 1, 1970) to the extent they would have been allowable under Defense Acquisition Regulation (Formerly ASPR) 15-205.34 or Federal Procurement Regulations section 1-15.205-34 in effect January 1, 1969.

(c) The allowability of rental costs under unexpired leases in connection with terminations is treated in 31.205-42(e).

## 2. Accounting Considerations.

A second requirement of cost allowability under FAR 31.201-2 (a) is that costs must be consistent with the standards promulgated by the CAS Board, if any are applicable; otherwise, the costs must be consistent with GAAP and accounting practices appropriate to the particular circumstances. The Cost Accounting Standards have been promulgated by the CAS Board for use by contractors and subcontractors in estimating, accumulating and reporting their costs in connection with all negotiated prime contract and subcontract procurements with the Government which meet certain established statutory thresholds.<sup>13</sup> Of these, only CAS 404, Capitalization of Tangible Assets, is *directly* applicable.<sup>14</sup>

CAS 404, found at 48 CFR § 9904.404, *et seq.*, applies to assets acquired by "capital lease" as defined by FAS 13. Compliance with FAS 13 and CAS 404 essentially requires that leases classified as capital leases be treated as purchased assets, with their capitalized values distributed over the useful lives of the leased assets as depreciation charges or over the lease

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<sup>13</sup>The thresholds which currently apply are basically receipt of a single \$25 million CAS-covered contract, or \$25 million total net CAS-covered awards received during the preceding cost accounting period, with at least one exceeding \$1 million. FAR 9903.201-2(a) (58 FR 58798, 11/4/93, effective 11/4/93; Corrected, 58 FR 65556, 12/15/93).

<sup>14</sup>To some extent CAS 414, Cost of Money as an Element of the Cost of Facilities Capital ("FCCM"), is also applicable, as it permits what is basically an imputed interest cost on a contractor's capital committed to a capital lease to be recovered as an element of contract cost. FCCM further applies as an element of the cost of ownership when a contractor's recovery is limited to costs of ownership.

Nevertheless, since CAS 414 only applies as noted above and is not itself referenced or incorporated so as to establish any inherent disputes, it is not necessary that CAS 414 be analyzed in any significant detail.

term as amortization charges. If a lease does not meet the capital lease criteria in FAS 13, it is classified as an "operating lease," with significantly different rules for determining what costs are allowable

Since both FAR 31.205-11(m) and FAR 31.205-36(a) expressly incorporate FAS 13 (as previously noted, a Financial Accounting Standard adopted by the accounting profession's governing body) as establishing the definitional standards to be applied in determining the proper lease classification, FAS 13 likewise plays a critical role in understanding the subject matter and issues that necessarily arise. As noted in *Denro, Inc. v. U.S.*, *supra*, "the accounting profession's Financial Accounting Standards Board (FASB) promulgates GAAP 'which are the conventions, rules and procedures that define accepted accounting practices.'"<sup>15</sup> Accordingly, accounting and its generally accepted practices also become relevant to the analysis.

With respect to FAS 13 and generally accepted accounting practices and procedures, the practitioner must remember that they all were developed to provide "guides to acceptable financial accounting practices, and not as guides to cost accounting."<sup>16</sup> Generally accepted accounting principles are factors to be considered for allowability, but they will not dictate reimbursability of a cost by the Government if the cost item in question does not meet the specific FAR allowability criteria.<sup>17</sup> Accordingly, since GAAP and cost accounting were

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<sup>15</sup>*Denro, Inc.*, *supra*, at p. 277 (citations omitted).

<sup>16</sup>*Physics International Company*, ASBCA 17700, 77-2 BCA ¶ 12, 612 at 61,143.

<sup>17</sup>See, e.g., *Riverside Research Institute*, ASBCA 28132, 87-2 BCA ¶ 19, 693 at 99,717.

developed with different purposes in mind, it must be expected that their joint application will result in significant application difficulties and interpretational disparities.<sup>18</sup> Our analysis, therefore, will look at all applicable accounting concepts in order to identify these conflicts to better understand what types of issues and arguments may arise.

### 3. The Contract Audit Manual.

Emphasis will also be placed on guidance disseminated to Government contracting officers in the Contract Audit Manual (CAM) published by the Defense Contract Audit Agency, DCAAM 7640.1.<sup>19</sup> The CAM does not represent "secret law" in the sense of refinements in the cost principles, as was argued a few years ago prior to its release to the

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<sup>18</sup>For a more detailed discussion of the differences between financial and cost accounting, and how they do not always coincide, see Howard W. Wright, *Accounting for Defense Contracts* 9, 29 (1962).

<sup>19</sup>*Cuneo v. Schlesinger*, 484 F.2d 1086, 1088, 157 U.S.App. D.C. 368, 370 (1973), notes that the DCAA "was established to provide necessary audit services to government officers in contract administration," advising the contracting officer whether costs comply with procuring agency criteria by conducting examinations of contractors' books and records.

As noted in its Foreword, the CAM "prescribes auditing policies and procedures and furnishes guidance in auditing techniques for personnel engaged in the performance of the DCAA mission." DCAAM 7640.1 at (3), (Jan. 1993).

The CAM further provides at 1-102a that the DCAA was established by DOD Directive to perform all its contract audit functions, including providing accounting and financial advisory services "to all DOD procurement and contract administration activities." *Id.*, at 101.

general public.<sup>20</sup> However, to the extent that it does “provide guidelines for what costs would be allowed under [the FAR], and rules or interpretations dealing with other substantive laws,”<sup>21</sup> the significance of its impact on treatment and allowance of contractors’ lease and rental costs by Government contracting officers and other contract officials cannot be understated. Therefore, it is clear that a thorough analysis of the subject must also involve a critical analysis of the CAM.

## B. STRUCTURAL FRAMEWORK OF THE ANALYSIS

This analysis generally will proceed in the order in which the various aspects of issues relating to the subject are presented in the basic cost principle (FAR 31.205-36). The distinction between the capital and operating lease classifications, which makes necessary the disparate treatment of the lease types, has brought about much of the confusion surrounding this subject, and constitutes the topic of detailed analysis in Chapter II. This analysis, which ultimately comes down to the accounting classifications and definitions developed in the accounting world, will delve heavily into cost and financial accounting. Nevertheless, thorough analysis will reveal that the fundamental concepts behind the classification criteria

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<sup>20</sup>*Cuneo v. Schlesinger, supra*, at 1089, 371.

<sup>21</sup>*Id.*, at 1090, 372.

are not all that hard to grasp, and exposing them at a basic level will facilitate understanding and working with them .

The second principal source of misunderstanding arises from treatment of costs in sale and leaseback situations, and is addressed in Chapter III. Once again, the factual circumstances and theoretical bases for treating transactions of this nature differently from those involving conventional leases are not necessarily what they might seem to the casual observer. Chapter III will highlight the applicable cost principles and address the true rationale that underlies that different treatment. It will also explore what factors will cause a transaction to be so characterized, and examine whether they are realistic and usable.

Chapter IV deals with leases and rental agreements between related parties or those under common control, which has been the third major area of significant disagreement. When the matter is dissected, it becomes clear that the fundamental reasoning underlying this allowability limitation is similar to that behind the treatment accorded sale-leaseback transactions. However, in Chapter IV we will deal strictly with how leases between parties under common control are treated, a frequently litigated aspect of contractor lease and rental costs. Through our analysis several important guidelines or practice pointers will become clear. These will be listed and examined in that chapter.

Chapter V then will address several miscellaneous aspects of lease and rental cost allowability having issues which have not been resolved in the previous chapters. These are, respectively, contractor leasing of electronic or automatic data processing equipment (ADPE), as defined under the applicable regulations, the handling of lease and rental costs in termination situations, and finally, the allowable cost determination issues and general

guidelines for working with them which the cost treatment accorded in various circumstances necessarily raises.

Finally, Chapter VI will conclude the analysis with the author's recommendation how the subject should be approached and considered by the practitioner to permit its proper use. Ultimately, this will require that the practitioner redouble his or her own efforts to work with what should be, with some slight adjustment, an adequate system.

### C. STATEMENT OF PURPOSE

This analysis accepts the premise that lease and rental cost allowability under Government contracts is generally a logical and reasonable approach to a significantly complex category of costs. However, its arcane treatment of the various forms of lease and rental agreements has resulted in an excessively complicated field of little-understood and little-appreciated distinctions. This has ultimately lead to a cost category that is, at best, highly susceptible to misapplication, or at worst, fraught with misuse as public funds are expended inappropriately.

If the subject inevitably must allow for misuse of the standards and regulations, whether due to misunderstanding, weak language, or clever manipulation, clearing up the defects is necessary. The easiest solution many might suggest would be merely to simplify the system as it now exists by modifying the cost principles to facilitate greater understanding by all involved, so that they can no longer be so easily misused. However, analysis of the cost



principles and their history reveals that there is good reason for their various provisions and complexities. It thus becomes clear that for the most part the system is not broken, but practitioners must gain the ability to work with it by redoubling their efforts to learn what is necessary to work with the existing system of causal relationships so that it can accomplish its logical goals.

The subject is not a simple one, and superficial analysis or avoidance are not acceptable. Working with lease and rental costs under the FAR requires an understanding of accounting concepts and some policy decisions. It also requires the ability to disregard some questionable and unreliable prior guidance. Taking the effort will benefit not only the Government and its practitioners, but also those practitioners in the private sector. Only when the playing field has been leveled can the fair and equitable results the subject deserves be attained.

## II. THE OPERATING/CAPITAL LEASE DISTINCTION

The first problem area that arises in applying the FAR lease and rental cost provisions involves the proper classification of the particular lease or rental agreement as an "operating" or "capital" lease. The treatment of the lease, including how much of its costs will be allowed and reimbursed to the contractor, varies dramatically depending upon which category the lease or rental arrangement falls into, or which classification applies. It is not surprising, therefore, that the proper classification of leases invariably will have the greatest economic impact of any lease-structuring election a contractor will make.

Before venturing into the specific provisions of the FAR applicable to the various lease classifications and their respective characteristics, it should benefit first to note a fundamental accounting and economic reality. Under ordinary circumstances a lessee will prefer recording leases on its books rather than recording assets and liabilities, since the former are shown as rental contracts which do not have to be reported as a debt on a balance sheet (commonly referred to as "off-balance-sheet financing"). Furthermore, leasing also offers additional benefits to lessees, including Government contractors, which range from such diverse considerations as the facts that no down payment is required, that available capital which otherwise would be tied up in property ownership instead is available for other uses, and that leasing can protect the lessee from other risks that are inherent in ownership of property, such as unexpected devaluation or destruction.

The analysis therefore begins from the perspective that as a general rule, a

Government contractor benefits from leasing. However, under some circumstances a lease agreement will be construed as the equivalent of a purchase of property, in which case the allowable rental costs will be limited to those that would be allowed if the property were instead owned by the contractor. Understanding what would cause a lease agreement to be treated as though the leased property were purchased, and the concepts which go along with the two lease classifications, therefore, is essential to understanding how a Government contractor's lease and rental costs will be reimbursed.

The FAR cost principles clearly set out the disparate treatment accorded the two categories of leases. FAR 32.205-36 provides, in part:

(a) This subsection is applicable to the cost of renting or leasing real or personal property, except ADPE (see 31.205-2), acquired under "operating leases" as defined in Statement of Financial Accounting Standards No. 13 (FAS- 13), Accounting for Leases.<sup>22</sup> Compliance with 31.205-11(m) requires that assets acquired by means of capital leases, as defined in FAS-13, shall be treated as purchased assets; i.e., be capitalized and the capitalized value of such assets be distributed over their useful lives as depreciation charges, or over the lease term as amortization charges, as appropriate (but see subparagraph (b)(4) below).<sup>23</sup>

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<sup>22</sup>Leases involving ADPE are discussed in detail in V.A, *infra*.

<sup>23</sup>Subparagraph (b)(4) is a "grandfather clause" providing that the previous Armed Services Procurement Regulation (ASPR) or Federal Procurement Regulation (FPR) cost principle provisions in effect January 1, 1969, whichever applied to the contracts at issue depending upon the contracting agency, remain applicable to those leases still executory which were entered into prior to March 1, 1970, when a cost principle revision substantially altering the treatment of leases came into effect.

Although there may be reported cases which have interpreted the legal effect of this provision and its application, it expressly excludes options exercised after that date. Even if it may still have some relevance, such provision is surely to be of decreasing applicability as time goes on. Accordingly, this analysis will not in any further detail.

(b) The following costs are allowable:

(1) Rental costs under operating leases, to the extent that the rates are reasonable at the time of the lease decision, after consideration of (i) rental costs of comparable property, if any; (ii) market conditions in the area; (iii) the type, life expectancy, condition, and value of the property leased; (iv) alternatives available; and (v) other provisions of the agreement.

The provision with which capital leases are required to comply, FAR 31.205-11(m), provides, in pertinent part:

(m) 48 CFR 9904.404, Capitalization of Tangible Assets,<sup>24</sup> applies to assets acquired by a "capital lease" as defined in Statement of Financial Accounting Standard No. 13 (FAS 13), Accounting for Leases, issued by the Financial Accounting Standards Board (FASB). Compliance with 48 CFR 9904.404 and FAS 13 requires that such leased assets (capital leases) be treated as purchased assets; i.e., be capitalized and the capitalized value of such assets be distributed over their useful lives as depreciation charges, or over the leased life as amortization charges as appropriate. Assets whose leases are classified as capital leases under FAS 13 are subject to the requirements of 31.205-11 while assets acquired under leases classified as operating leases are subject to the requirements on rental costs in 31.205-36. The standards of financial accounting and reporting prescribed by FAS 13 are incorporated into this principle and shall govern its application, except as provided in subparagraphs (1), (2), and (3) below.<sup>25</sup>

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<sup>24</sup>48 CFR 9904.404 is a Cost Accounting Standard (CAS) which provides the accounting treatment that contractors are required to follow regarding the capitalization of tangible assets so their costs will be consistently allocated to cost objectives over the present and future accounting periods.

The CAS were adopted pursuant to Public Law 100-679 (41 U.S.C. § 422), which requires contractors and subcontractors to comply with the CAS and to disclose in writing and follow consistently their cost accounting practices.

<sup>25</sup>Subparagraphs (1) (2) and (3) of this cost principle address sale and leaseback arrangements, leases between related parties, and leases entered into before March 1, 1970. Sale and leaseback arrangements are discussed in detail in Chapter III, *infra*, and leases between related parties (parties under common control) are discussed in Chapter IV, *infra*.

As explained in note 23, *supra*, the treatment of leases entered into prior to 1970 will

The two cost principles show that cost allowability varies with how a lease is classified.<sup>26</sup> Leases classified as capital leases are subject to what is frequently a significant cost allowability limitation, *i.e.*, costs cannot exceed the costs that would be allowed if the leased property was purchased and depreciated. The allowability of costs incurred under operating leases, on the other hand, are limited only by the basic requirement that they be reasonable. Such reasonableness is determined by comparison with lease amounts incurred for comparable properties for like uses, executed at about the same time under like circumstances, supplemented by general FAR reasonableness provisions of FAR 31.201-3. In other words, lease amounts that are allowable when they are incurred under capital leases will, in ordinary circumstances, be significantly less than those that are allowed under operating leases, due to the substantially differing natures of the two lease types.<sup>27</sup>

In order to increase the allowable amount which will be reimbursed by the Government, a Government contractor might attempt to structure its leases so that they are classified as operating leases, even though they are actually capital leases.<sup>28</sup> It is clear that

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not be further addressed.

<sup>26</sup>See Chapter V.C, *infra*, for a breakdown of what costs are allowable under the specific lease classification or variation.

<sup>27</sup>*Engineering Incorporated*, NASA BCA 187-2, 88-2 BCA ¶ 20, 792, at 105,035 states that the significance of the difference between the classifications is that costs incurred under capital leases are recovered through depreciation. See Chapter V.C, *infra*, for a more detailed analysis.

<sup>28</sup>The CAM, which as previously discussed furnishes guidance to assist Government auditors, seems to be written with the view that contractors *will always* try to get more money from the Government through any number of inappropriate means. It warns its auditors of the possibility of potential subterfuge by contractors in rather blunt language, stating in 7-203.2a(2) that "[a]uditors should be alert to instances where, to avoid reporting

determining the proper classification of a particular lease, based on as objective a standard as can be fashioned, is of utmost importance. As to this, both cost principles defer to the accounting world's definitions and expertise, referencing Statement 13 of the Financial Accounting Standards Board as the definitional authority. That Statement provides, in relevant part:

7. The criteria for classifying leases set forth in this paragraph and in paragraph 8 derive from the concept set forth in paragraph 60.<sup>29</sup> If at its inception (as defined in paragraph 5(b)) a lease meets one or more of the following criteria, the lease shall be classified as a capital lease by the lessee. Otherwise, it shall be classified as an operating lease. (See Appendix C for an illustration of the application of these criteria.)

- a. The lease transfers ownership of the property to the lessee by the end of the lease term (as defined in paragraph 5(f)).
- b. The lease contains a bargain purchase option (as defined in paragraph 5(d)).
- c. The lease term (as defined in paragraph 5(f)) is equal to 75 percent or more of the estimated economic life of the leased property (as defined in paragraph 5(g)). However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

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liabilities on their financial statements, contractors may structure their leases, or include assumptions in testing against the FASB Statement 13 criteria, that result in [capital] leases being classified as operating."

<sup>29</sup>Paragraph 8 of FAS 13 concerns classification of leases from the standpoint of the lessor, adding such concepts as a "sales-type" lease and a "direct financing" lease. Such material is not relevant to Government contracts costing, and will not be addressed herein.

Paragraph 60 explains that the conclusions in the Statement are derived from the view that leases which transfer "substantially all of the benefits and risks incident to the ownership of property" are similar in economic effect to installment purchases, and should be classified as capital leases.

- d. The present value at the beginning of the lease term of the minimum lease payments (as defined in paragraph 5(j)), excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property (as defined in paragraph 5(c)) to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by him. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for the purposes of classifying the lease. A lessor shall compute the present value of the minimum lease payments using the interest rate implicit in the present value in paragraph 5(k)). A lessee shall compute the present value of the minimum lease payments using his incremental borrowing rate (as defined in paragraph 5(l)), unless (i) it is practicable for him to learn the implicit rate computed by the lessor and (ii) the implicit rate computed by the lessor is less than the lessee's incremental borrowing rate. If both of those conditions are met, the lessee shall use the implicit rate.

The detailed and complex accounting guidelines contained in FAS 13 were written by accountants for accountants. They may be something a Certified Public Accountant or practitioner in the field of accounting is comfortable with, but they present a difficult challenge to many Government contracts lawyers. Fortunately, it is not necessary for the lawyer-practitioner to understand all the various subtleties of the subject in order to work with it under ordinary circumstances in the legal realm. It should be sufficient if he or she has at least a rudimentary knowledge of the accounting-based concepts so as to enable the practitioner to be of valuable service to the Government contractor client.

This must begin with the realization that no analysis of specific lease provisions should be undertaken without employing the services of an accountant. Also, the Financial

Accounting Standards must be consulted and analyzed, and opinions and interpretations of the Financial Accounting Standards Board for how they should be applied. This chapter will address the concepts and underlying rationales behind the differing classifications. It is unquestionably of great value for the legal practitioner to acquire at least a basic understanding of the fundamentals of these two lease categories and their characteristics, and it is not a herculean task.

This Chapter, therefore, will explain these rules by defining the fundamental concepts, then identifying what essential features and provisions of a contractor's lease agreement will cause it to be classified as one or the other type. We will then analyze the determination of what lease terms and types of arrangements will achieve the results sought by the contractor. Finally, we will look at some of the ways the disparate treatment can lead to misuse, and suggest ways to prevent it.

## A. THE OPERATING LEASE PRESUMPTION

The basic structure of FAS 13 pertains to the classification of leases and their proper accounting treatment, proceeding from the general proposition that, unless the parties express a contrary intent, a lease will be classified according to the circumstances as of the date of



inception of the lease.<sup>30</sup> Such a lease, except in certain limited exceptions which are not applicable to Government contracting and need not be addressed here, will be presumptively deemed to be an operating lease unless it:

- (1) transfers ownership to the lessee at the end of the lease term (as defined therein);
- (2) contains a "bargain purchase option;"
- (3) is for 75% or more of the property's economic life (unless the lease term does not begin until the last 25% of its total estimated economic life, in which case this criterion is not be applicable); or
- (4) has "minimum lease payments," the present value of which, after removing that portion of its "executory costs" that are to be paid by the lessor including profit thereon, amounts to at least 90% of the excess of the fair value of the property to the lessor at the lease inception, over any related investment tax credit the lessor expects to realize on the property.

As it applies to Government contractors, then, if *any* of these criteria is satisfied the lease will be classified as a capital one.<sup>31</sup> That classification will result in the allowable costs

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<sup>30</sup>Paragraph 5(b) generally defines "inception of the lease" as being the earlier of the date of the lease agreement or a signed written commitment containing the principal terms of the transaction. If the property has yet to be constructed or acquired by the lessor, lease inception is when construction is complete or the property acquired.

Paragraph 9 describes the accounting treatment to be accorded a lease which is modified during the time in which it is in effect, providing that if it would have meant that the lease would have been classified differently had those terms been in it at its inception, such shall be considered as if it were a new lease with its inception as of that date.

<sup>31</sup>Notwithstanding this rule, in FASB Technical Bulletin No. 79-10, dated December 28, 1979, the Financial Accounting Standards Board stated that the existence of a fiscal funding clause in a lease agreement may cause a lease to be considered an operating lease.

In other words, a capital lease agreement could be considered an operating lease instead by virtue of a clause making the rent contingent upon continued fiscal funding by the Government. Such a clause essentially makes the lease cancelable for purposes of calculating the lease term. (See notes 33 and 37, *infra*.)

being limited to normal ownership costs, notwithstanding how much the contractor is incurring.<sup>32</sup>

## B. THE PRESUMPTION REBUTTED: CAPITAL LEASES

In the sections which follow hereafter, each capital lease criterion will be analyzed separately. Where necessary, this analysis will determine the practical meaning that has been ascribed to each criterion, and analyze how consistent that given meaning is with the general intent underlying FAS 13.

### 1. Leases Transferring Ownership.

A lease is classified as capital if it transfers ownership to the lessee at the end of the lease term.<sup>33</sup> Such a lease is, for all practical effects and purposes, the equivalent of a contract

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<sup>32</sup>See Chapter V.C, *infra*, for a more detailed discussion of the various cost elements that are allowed for owned property, compared to those allowed for property acquired under operating leases.

<sup>33</sup>"Lease term" is defined under paragraph 5(f) as essentially being the time period over which the lease extends and during which it cannot be canceled without the lessor's permission, plus certain option periods. See note 38, *infra*, for a more complete analysis of the specifics of how this phrase is used under FAS 13 analysis.

for purchase with the purchase price paid through monthly installments. At the end of the lease term, including all option periods reasonably expected to be exercised (and which are required to be included as part of the lease term by FAS 13, as discussed in note 5 above), the lessee is the owner of the property.<sup>34</sup> Accordingly, the lease and its related costs are treated as though the property were owned by the contractor. Of course, in those circumstances in which a lease agreement expressly provides for ownership to be transferred to the lessee at the end of the lease term, it is highly unlikely there would ever be a dispute as to the proper accounting treatment or cost allowability under the FAR. Rather, disputes as to the proper classification are far more likely to arise where the lease/rental agreement is alleged to meet one of the other criteria set forth in FAS 13.

## 2. Leases With Bargain Purchase Options.

A "bargain purchase option" is defined in FAS 13 as:

"[a] provision allowing the lessee, at his option, to purchase the leased property for a price which is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured."<sup>35</sup>

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<sup>34</sup>On superficial analysis, it might seem appropriate that only leases of this nature support treatment that is equivalent to ownership. However, paragraph 69 of FAS 13 expressly notes that it considered including only leases of this nature which are "in substance installment purchases" as a basis for lease capitalization, but rejected that as too limiting.

<sup>35</sup>FAS 13, paragraph 5(d).

This means that leases which give the lessee an option to purchase the demised property for an amount which is so much lower than the property's expected fair value at that time as to render it reasonably sure that the lessee will in fact exercise that option, the lease will be treated as a capital one.

There is unfortunately little guidance to aid in working with this classification criterion other than accounting interpretations, and there are no reported cases in which contractors have appealed cost disallowances based upon it. Nevertheless, it is logical and consistent with the FAS that the presence of such option terms would render the lease a capital one, since such has the economic effect of transferring to the lessee the risks and benefits of ownership.<sup>36</sup> Absent some other provisions, it is assumed that including such a clause in a lease makes the lessee's purchase of the property inevitable.

Thus, a contractor's lease or rental agreement which gives the contractor such favorable terms for purchase as to make the exercise of that option a reasonably assured occurrence will be treated as a capital lease, with costs allowed only to the extent they do not exceed the costs had the contractor owned the property.

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<sup>36</sup>See FAS 13, paragraph 60, discussed in note 29, *supra*. If a lessee and lessor have an agreement which includes a bargain purchase option, reached after bargaining in good faith, it is reasonable to assume that some portion of the rental payments made during the term of the lease would have been in the nature of a prepayment of the ultimate purchase price, with the lessee expected to exercise the option. The periodic lease payments thus would be similar in concept to installment purchase payments with the equivalent of a balloon payment made when the purchase option is exercised.

### 3. Leases for Terms Exceeding 75% of the Estimated Economic Life of the Leased Property.

The third category of leases which are classified and treated as capital leases are those in which the lease term<sup>37</sup> is equal to 75% or more of the estimated economic life of the leased property. A significant exception exists where the lease term does not begin until the last 25% of the estimated economic life of the property, in which case this criterion is not used to classify the lease. (If not for such exception, this criterion would treat older properties

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<sup>37</sup>Paragraph 5(f) of FAS 13 defines "lease term" basically as the fixed term of the lease, which is essentially noncancelable from the lessee's perspective, and to which it is bound, absent the occurrence of some remote contingency. The lease term also includes:

1) all option periods to which the lessee is given the right to renew for less than the fair rental of the property at the date the option becomes exercisable (known as "bargain renewal options") as well as all option periods preceding these, irrespective of their rental amounts;

2) all periods for which the lessee is sufficiently penalized for failure to renew so as to reasonably render assured that such renewal will take place;

3) all periods covered by renewal options during which there exists a lessee guarantee of the lessor's debts related to the property; and

4) all periods during which the *lessor* possesses some enforceable right to require the lessee to renew.

In FASB Technical Bulletin No. 79-11, dated December 28, 1979, the Financial Accounting Standards Board of the Financial Accounting Foundation stated that the "penalty" referred to in paragraph 5(f) of Statement 13 is not limited to a penalty imposed by the lease agreement. That paragraph states that the lease term includes "all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured." FASB Statement 98, effective July 1988, formally modified the definition of "lease term" to suggest that exercising a cancellation clause itself imposes a penalty.

Accordingly, the lease term would include any periods for which failure to renew the lease would result in an economic penalty as a result of factors external to the lease, so long as (a) the existence of the penalty was known at the inception of the lease, and (b) the nature and estimated amount of the penalty at the inception of the lease was such that renewal would appear to be reasonably assured.

unfairly since it would cause a lease of older property to be treated as a capital one automatically, notwithstanding terms which otherwise might meet the other FAS 13 characteristics of an operating lease.)

For the purpose of applying this criterion, FAS 13 defines the "estimated economic life of leased property" as the estimated remaining period of time during which the property is expected to be usable in an economic sense by one or more users, requiring only normal repairs and maintenance, for the purpose for which it was intended at the lease's inception, without limitation by the lease term.<sup>38</sup> Therefore, as to Government contractors the estimated economic life of leased property will generally be that period of time in which the property may be used productively for performance of Government contracts, with only normal repairs and maintenance.

Consistent with the wording of this criterion, then, if a Government contractor leases property for a period of time equal to or exceeding 75% of the estimated economically useful life of that property, the lease agreement will be classified as though it were a capital lease. The costs incurred under such a lease will be allowable only to the extent they do not exceed what they would be if the leased property were owned.

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<sup>38</sup>FAS 13, paragraph 5(g). The last phrase of this definition appears ambiguous as to whether it means that what is considered a property's estimated economic life may not be limited by its lease term, as discussed above, whether it is the property's economic usability that may not be so limited, or whether it is the property's intended use. However, it is not critical to a basic understanding of the overall concept of a property's economic life that this ambiguity be clarified, so this subject will not be addressed further.

#### 4. Leases With Payments Equaling or Exceeding 90% of the Property Value.

The final criterion set out under FAS 13 for classifying a lease as a capital one is by far the most complicated of the four, potentially the one most susceptible of being misunderstood, and probably the one most frequently misused. Nevertheless, this criterion has been characterized as being the one intended by the FASB to be the "key factor in determining the existence of a capital lease,"<sup>39</sup> and elsewhere has been analyzed as incorporating within itself all four criteria, so as to result in the other three for the most part being merely redundant.<sup>40</sup>

As is clear from the formidable (and verbose) wording of the criterion, there are several phrases ("estimated residual value," "unguaranteed residual value," "minimum lease payments," "interest rate implicit in the lease," and "lessee's incremental borrowing rate") which must be understood in order for the practitioner to grasp what the criterion intends. The provisions of FAS 13 define each of these phrases, and the manner in which each phrase applies to lessees in the classification of their leases, is set forth below:

- h. *Estimated residual value of leased property.* The estimated fair value of the leased property at the end of the lease term (as defined in paragraph 5 (f)).
- I. *Unguaranteed residual value.* The estimated residual value of the

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<sup>39</sup>Jay M. Smith, Jr. & K. Fred Skowsen, *Intermediate Accounting, Comprehensive Volume*, p. 910 (9th ed. 1987).

<sup>40</sup>See John W. Coughlan, "Regulations, Rents, and Residuals," *Journal of Accountancy* (February 1980), pp. 58-66.

leased property (as defined in paragraph 5(h)) exclusive of any portion guaranteed by the lessee<sup>41</sup> or by a third party unrelated to the lessor.<sup>42</sup>

j. *Minimum lease payments.*

1. From the standpoint of the lessee: The payments that the lessee is obligated to make or can be required to make in connection with the leased property. However, a guarantee by the lessee of the lessor's debt and the lessee's obligation to pay (apart from the rental payments) executory costs such as insurance, maintenance, and taxes in connection with the leased property shall be excluded. If the lease contains a bargain purchase option, only the minimum rental payments over the lease term (as defined in paragraph 5(f)) and the payment called for by the bargain purchase option shall be included in the minimum lease payments. Otherwise, minimum lease payments include the following:

- a. The minimum rental payments called for by the lease over the lease term.
- b. Any guarantee by the lessee<sup>43</sup> of the residual value at the expiration of the lease term, whether or not payment of the guarantee constitutes a purchase of the leased property. When the lessor has the right to require the lessee to purchase the property at termination of the lease for a certain or determinable amount, that amount shall be considered a lessee guarantee. When the lessee agrees to make up any deficiency below a stated amount in the lessor's realization of the residual value, the guarantee to be included in the minimum lease payments shall be the stated amount, rather than an estimate of the deficiency to be made up.

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<sup>41</sup>Under the FAS 13 provisions, a guarantee by a third party related to the lessee is considered the same as a guarantee by the lessee.

<sup>42</sup>The FAS 13 provisions in this regard state that in circumstances in which the guarantor of the estimated residual value of the leased property is related to the lessor, the residual value shall be considered as unguaranteed, at least as far as the lessee is concerned.

<sup>43</sup>See note 41, *supra*.



- c. Any payment that the lessee must make or can be required to make upon failure to renew or extend the lease at the expiration of the lease term, whether or not the payment would constitute a purchase of the leased property. In this connection, it should be noted that the definition of lease term in paragraph 5 (f) includes "all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured." If the lease term has been extended because of that provision, the related penalty shall not be included in minimum lease payments.

\* \* \*

- k. *Interest rate implicit in the lease.* The discount rate that, when applied to (i) the minimum lease payments (as defined in paragraph 5(j)), excluding that portion of the payments representing executory costs to be paid by the lessor, together with any profit thereon, and (ii) the unguaranteed residual value (as defined in paragraph 5(i)) accruing to the benefit of the lessor,<sup>44</sup> causes the aggregate present value at the beginning of the lease term to be equal to the fair value of the leased property (as defined in paragraph 5(c)) to the lessor at the inception of the lease, minus any investment tax credit retained by the lessor and expected to be realized by him. (This definition does not necessarily purport to include all factors that a lessor might recognize in determining his rate of return, e.g., see paragraph 44.)<sup>45</sup>

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<sup>44</sup>An explanatory footnote in FAS 13 explains that where the lessor is not entitled to any excess of the amount realized on disposition of the property over a guaranteed amount, no unguaranteed residual value accrues to his benefit. As discussed *infra*, the absence of any unguaranteed residual value has the practical effect of raising what is considered the interest rate implicit in the lease.

<sup>45</sup>Paragraph 44 deals with how a lessor computes its rate of return on its net investment in the leased property, and is not relevant to this analysis.

1. *Lessee's incremental borrowing rate.* The rate that, at the inception of the lease, the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset.

To assist in working through the intricacies of this 90% criterion, this analysis will use a hypothetical Government contractor, Contractor A. When the fundamental concepts and purpose behind this criterion are understood, several striking observations can be made as to the relationships that exist between the various factors. From these observations the manner in which the criterion may be misused or abused should become manifest.

The first step in working with this "90% criterion" requires that the "minimum lease payments" required under a lease agreement be determined. That amount is calculated first by establishing as a baseline the amount which under the terms of the lease agreement the lessee is required to pay as rental, with various amounts being subtracted from or added to such baseline as required under the paragraph 7 calculation. Such amount is reduced first by the extent to which the lessee guarantees the lessor's debt connected with the leased property, and by whatever amount the lessee is obligated to pay (apart from its rental payments) in so-called executory costs, such as insurance, maintenance, and taxes on the leased property.<sup>46</sup>

If a lease agreement contains a bargain purchase option (see subsection B.2, *supra*), the bargain purchase option amount is added to the total of the minimum rental payments over the lease term to arrive at the minimum lease payments amount. However, in all other

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<sup>46</sup>"Executory" costs, which frequently include maintenance, insurance, taxes and utilities, are amounts which are not determined in advance.

circumstances the minimum lease payments ("MLP") amount is determined by aggregating:

- (1) the minimum rental payments called for in the lease over the entire lease term;<sup>47</sup>
- (2) any amount by which the lessee is required to guarantee the residual value of the leased property at the expiration of the lease term (whether or not such constitutes a purchase of the leased property);<sup>48</sup> and
- (3) any amount which the lessee will be required to pay by reason of its failure to renew or extend the lease at the expiration of the lease term (again, whether or not such would constitute a purchase of the property).<sup>49</sup>

For example, if Contractor A leases an asset (real or personal) under a basic five-year lease which calls for simple monthly payments of \$20,000, with no requirement for a residual lease guarantee by the lessee or penalty for failing to renew when the five years term is up, the

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<sup>47</sup>The CAM provides at ¶ 7-204.2b that lease payments that depend on an existing index or rate, such as the CPI or prime interest rate, shall be included in minimum lease payments based on the index or rate existing at lease inception. Any future increases or decreases in that rate are excluded from the minimum lease payments entirely.

<sup>48</sup>The provision states that in those situations where a lease agreement requires the lessee at the expiration of the lease term to make up any deficiency in the property's residual value below a stated amount, the amount of the guarantee to be included in the minimum lease payments is to be that stated amount, rather than the estimate of what the deficiency will be.

The provision further directs that where the lessor is given the right under the agreement to require the lessee to purchase the property at the termination of the lease for an amount which is certain or determinable, that amount also shall be considered a lessee guarantee. Provisions of this nature do not by themselves cause the lease to be a capital one, but only cause the amount of the minimum lease payments to increase for purposes of this fourth criterion.

<sup>49</sup>If the lease term has been extended by reason of the FAS 13 paragraph 5(f) requirement to include periods for which the lessee is penalized for not renewing the lease (see note 37, *supra*), the amount by which the lessee is so penalized is not included within the minimum lease payments.

minimum lease payments amount would be \$1,200,000.

Once the minimum lease payments amount has been calculated, that amount is reduced down to its "present value" according to the directions set forth under the criterion, as of the beginning of the lease term.<sup>50</sup> As far as the lessee is concerned, the present value of the minimum lease payments is computed by multiplying the amount of the minimum lease payments as calculated above either by the lessee's "incremental borrowing rate," or, if it is practicable for the lessee to learn the "interest rate implicit in the lease" computed by the lessor and this latter rate is less than the lessee's incremental borrowing rate, then by this implicit rate.<sup>51</sup> It is necessary to analyze what these phrases mean (and in some cases, what their definitions given under FAS 13 actually mean), so that they can be understood by the non-accountant practitioner.

The lessee's incremental borrowing rate, as defined in paragraph 5(l) above, is relatively easy and straightforward to determine. It is simply the rate which as of the time of lease inception the lessee would have incurred to borrow (over a term similar to that of the lease) the funds required for it to purchase the leased property. The lessee's incremental borrowing rate, therefore, is whatever discount (interest) rate at which the lessee would have

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<sup>50</sup>This requirement is logical and consistent with the fundamental initial perspective of FAS 13 as discussed in section A, *supra*, in that it focuses the analysis on the leasing parties' relationship as of the inception of the lease. It is therefore not necessary to wait until a lease agreement has been fully performed in order to perform the computations required to classify it.

<sup>51</sup>In *Engineering Incorporated*, NASA BCA 187-2, 88-2 BCA ¶ 20, 792, at 105,035, the Board defines "present value" as a concept under FAS 13 for appraising the current worth of delayed payments. It states that computing the present value of lease payments requires a determination of interest rates, the fair value of the asset, and executory costs.

been able to obtain to borrow money to purchase outright the leased property, had it been for sale, instead of merely leasing it.<sup>52</sup>

As set forth below, in those circumstances in which the lessee's incremental borrowing rate ("LBR") is used, the present value of the minimum lease payments ("PV") is determined by applying that rate to the amount of the minimum lease payments ("MLP") that was determined by the process previously recited. By definition previously recited, the amount of the minimum lease payments is the total amount paid by the lessee over the term of the lease, excluding executory costs such as insurance, maintenance and taxes which are paid by the lessee.

$$PV=(LBR)(MLP)$$

If in the hypothetical case of Contractor A it is assumed that it could have borrowed at 15% to purchase, the present value of the minimum lease payments would be \$180,000.

The present value calculation is somewhat more complicated when it also requires consideration of the rate that is implicit in the lease. This concept of a lease's implicit rate introduces the further concept of "unguaranteed residual value" into consideration, as that phrase is used by FAS 13. It is critical that both of these phrases be understood in order to

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<sup>52</sup>In FASB Technical Bulletin No. 79-12, dated December 28, 1979, the Financial Accounting Standards Board stated that a lessee may use its secured borrowing rate in calculating the present value of minimum lease payments in applying the provisions of Statement 13.

The incremental borrowing rate is defined in paragraph 5(1) as "the rate that...the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset." The Bulletin reasons, therefore, that paragraph 5(1) does not proscribe the lessee's use of a secured borrowing rate as its incremental borrowing rate if that rate is determinable, reasonable, and consistent with the financing that would have been used in the particular circumstances.

work with the criterion, as it is from the concept of a leases's implicit rate that the criterion seems especially susceptible to potential abuse.

As defined under FAS 13 paragraph 5(l), the unguaranteed residual value of leased property is its estimated fair value at the end of the lease term (including any option periods required to be included, as elsewhere defined in FAS 13<sup>53</sup>), also referred to as its estimated residual value, exclusive of any part of which was required to be guaranteed by the lessee, by a third party related to the lessee, or by a third party that is unrelated to the lessor. The unguaranteed residual value of leased property is therefore basically what it is estimated the property will be worth at the end of the lease.

As set out in the equation below, determining the interest rate implicit in a lease ("IR") requires determining what discount rate must be applied to the aggregate of: (1) the minimum lease payments ("MLP") (the same amount as previously calculated, which again excludes executory costs to be paid by the lessor, together with any profit thereon), and (2) the unguaranteed residual value ("URV") of the leased property, so that the present value of such aggregated sum at the beginning of the lease term is equal to the fair value of the leased property to the lessor ("FMV") at the inception of the lease (less any investment tax credit retained by the lessor and expected to be realized by it).

$$IR(MLP + URV) = FMV$$

Mathematically rearranged, IR equals  $FMV/(MLP+URV)$ . This more clearly shows that as the aggregate of the MLP and the URV increases, the IR gets proportionately smaller,

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<sup>53</sup>See note 37, *supra*, for a discussion of what constitutes the "lease term" and what option periods are required to be included within its coverage.

since the property's FMV at lease inception remains the same.

In the Contractor A example, assume that the value of the property to the owner/lessor as of lease inception (FMV) is \$1,000,000 and after five years of use it will have a residual value of \$800,000. There are no residual value guarantees by the lessee or a party related to it. Under the rearranged formula last stated, the IR thus can be calculated as the FMV (\$1,000,000) divided by the aggregate of the MLP and URV amounts (\$1,200,000 + \$800,000), or 50%. Since 50% is greater than the lessor's 15% incremental borrowing rate (LBR) previously stated, the lease's implicit rate is irrelevant for our purposes in making the 90% criterion evaluation.

Again rearranging this last equation mathematically (but without altering its content) reveals, as noted in the equation set out below, that the amount of a lease's minimum lease payments is equal to the fair value of the leased property to the lessor at lease inception, divided by the lease's implicit rate, less the unguaranteed residual value of the leased property as of the date the lease is terminated.

$$\text{MLP} = \text{FMV} / \text{IR} - \text{URV}$$

As again set forth below, if the lessee can obtain the lease's implicit rate from the lessor, and that amount is lower than the lessee's incremental borrowing rate, the present value of the minimum lease payments is determined instead by applying the lease's implicit rate to the amount of the minimum lease payments as previously calculated. (It must be remembered that the present value of the minimum lease payments amount calculated using this implicit rate is different from that which was calculated using the lessee's incremental borrowing rate as previously analyzed, so that PV here does not equal the PV in the formula

previously provided.)

$$PV = (IR)(MLP)$$

Some further interesting relationships between these various amounts, and how they affect each other, appear when the MLP amount from the formula preceding this last one is substituted in this last-cited equation. As shown below, this reveals that the present value of the minimum lease payments (PV) equals the fair value of the leased property (FMV), less the product of the lease's implicit rate (IR) applied to the unguaranteed residual value of the leased property (URV).

$$PV = FMV - (URV)(IR)$$

Before proceeding, it is necessary now to remember that the instant criterion causes a lease to be classified as capital if the present value of the minimum lease payments (PV) is greater than or equal to 90% of the property's value at lease inception. Using the PV determination formula last cited reveals that a lease will be classified as capital if the FMV, less the (URV)(IR) product is greater than or equal to 90% of the fair value of the property at lease inception.

$$FMV - (URV)(IR) \geq .90(FMV)$$

Rearranging this last formula reveals, as shown below, that a lease is classified as capital under this criterion only if the fair value of the leased property at lease inception (FMV) is equal to, or greater than, ten times the product of the lease's implicit rate (IR) applied to the unguaranteed residual value of the leased property (URV).

$$FMV \geq 10(IR)(URV)$$



Stated another way, a lease will *not* be classified as capital if ten times the product of the leases's IR and its URV is greater than the property's FMV at lease inception. In such event, the lease will be classified as operating.

For Contractor A, if its lease's IR could be made to be less than the contractor's borrowing rate (LBR), its lease would be classified as capital under this criterion only if the FMV at inception (\$1,000,000) is greater than or equal to ten times the product of the IR, applied to the property's URV. Otherwise, the lease will be classified as operating, and all the lease costs will be allowed as long as they are reasonable.

A contractor thus can ensure that its lease will be classified as an operating lease, according to the guidelines of this criterion, as long as the leased property's value to the lessor at lease inception is less than ten times the product of the discount rate implicit in the lease applied to what the property is estimated to be worth at the termination of the lease. Analyzed in such a way, it begins to become clear that by manipulating the various numbers there are ways in which FAS 13 and its rules could be misused or abused.

### C. AREAS OF POTENTIAL MANIPULATION, ABUSE OR MISUSE

Use of the accounting and reporting requirements set forth in FAS 13 can result in a significant distortion of economic reality, and through such distortion a windfall can accrue

to the contractor. One such way FAS 13 might invite misuse, even in leases properly classified as operating leases, can be seen in how a contractor's annual rental payments are reported, how those amounts are paid, and how such lease costs are allowable and properly reimbursable by the Government to the contractor. Another potential abuse or misuse of the FAS 13 criteria can be seen in the potential it seems to invite for contractor classification manipulation. In the sections which follow, some of the ways the cost principles and FAS 13 potentially could be manipulated, abused or misused will be addressed, with the primary intention either of seeing that loopholes be closed, or at least placing the Government and contractor practitioners on notice that the potential for problems exists.

#### 1. Accounting for Leases.

In practice, many leases contain rental terms which provide for varying rental payments over the lease term, often calling for lower amounts in the first years, with scheduled increases in later years. Sometimes these lease agreements even go so far as to provide even more favorable terms to prospective lessees in order to induce them to enter into the agreements, frequently even permitting a lessee to occupy the leased property for a period at the outset without any rent being due. The contractor under such an arrangement is thus given the use of rental or leased property without paying out any money during that period, essentially getting the property "rent-free."

According to the terms of FAS 13,<sup>54</sup> when rental payments vary over the lease term, the rental expenses are required to be recognized on a "straight-line" basis, unless there is another basis which more accurately represents the time pattern for which benefit accrues to the lessee. In other words, FAS 13 requires that the total amount of lease payments be aggregated and allocated out on a straight-line basis over the length of time (term of the lease) during which the leased property is used.

The problem this creates where lessees are performing Government contracts is determining the amount that should be properly allowed and reimbursable by the Government. If, for example, the first year of a five-year lease is rent-free to Contractor A, with the last four years at \$25,000/month (for a total rental amount over the lease term of \$1,200,000), FAS 13 directs that the lease amount be recognized at \$240,000/year over the lease term. Contractor A's "books" will show that it incurred a "rent expense" (actually a "rent payable") of \$240,000 in the first year, and it could claim that amount as an incurred and reimbursable cost (in its provisional indirect rates) for that first and the following years, even though it actually paid nothing that first year and only made up the \$240,000 over the remaining four years.

While the Government will properly have paid the entire lease amount as of the end of the lease term, it essentially will have given the contractor interest-free use of the \$240,000, or parts of it, for up to five years. Furthermore, if for some reason the contract is

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<sup>54</sup>Paragraph 15 of FAS 13 stipulates that if rental payments are not made on a straight-line basis, the rental expense amount "nevertheless shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis shall be used."

terminated prior to its completion, complying with FAS 13 may result in the Government having paid out substantially more than that to which the contractor was entitled, thereby exacerbating the problem.

Preventing what is essentially tantamount to advance payments to Government contractors will require that Government officials, their auditors and counsel, be aware of such possibility and be watchful of its occurrence. Knowing that FAS 13 treatment calls for straight-line amortization of lease costs which vary over the lease term may prevent the potentially foreseeable abuse of what to Government officials is probably a little-known requirement of FAS 13.

## 2. Classification Manipulation.

As suggested by the various formulae cited above under the fourth criterion of FAS 13, and the relationships that can be seen to exist between the various elements, how a particular lease will be classified especially under this criterion presents an opportunity for

manipulation, abuse or misuse of lease and rental agreements by Government contractors.<sup>55</sup>

This criterion literally seems to invite such manipulation. As note by Professors Smith and Skowson, since FAS 13 was first drafted, a new industry of third-party financing has been created to take advantage of the benefits offered by residual value guarantees.<sup>56</sup>

Looking first to the formulae applicable to working with a lease's implicit rate as set out above, the benefit to the lessee of manipulating the various numbers becomes clear. Initially, it can be observed that the fair value of the leased property to the lessor at the inception of the lease (FMV) is a constant, not subject to great variation or manipulation as long as there are similar properties for comparison and reasonably reliable appraisers. Therefore, since we have determined that  $IR(URV + MLP) = FMV$ , the lease's IR will be a function of the size of the aggregate of the URV and the MLP. The IR is inversely related to the URV and MLP amounts, in that whenever the aggregate of them gets greater in amount, the IR gets proportionately lower. Accordingly, when the URV or the MLP, or either of them, is large, the IR will be relatively low.

Further, the present value of the minimum lease payments (PV) is calculated by applying to the MLP amount (as previously defined) by either the lessee's LBR or the IR of

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<sup>55</sup>Actually, this fourth criterion seems to present the greatest, but not the only, potential basis for classification manipulation of all the FAS 13 criteria. At least theoretically any of the four could be manipulated, such as by creating "straw men" to hide the fact that the lessee is given ownership at lease termination, by giving a lessee an option to purchase the property for a price at slightly above a "bargain purchase" amount, by inflating a property's estimated economic life, *etc.* For purposes of this analysis, only that manipulation which would seem least likely to be observed will be addressed.

<sup>56</sup>Smith & Skowson, *supra*, p. 910.

the lease. However, the lease will only be classified as a capital lease under this criterion if the PV equals or exceeds 90% of the fair value of the leased property at lease inception (FMV). Accordingly, if the contractor's lease payments are large and appear to be approaching this "90% criterion," the contractor will want to ensure that its lease is classified as operating by having as low a factor as it can to apply to its MLP amount so that it will be less than 90% of the FMV.

A contractor thus would have an incentive to do what it can to achieve the lowest possible discount rate. A review of the two discount rates involved in lease classification shows that the LBR, absent some form of collusive or less-than-arm's length arrangement for financing below market rates, is not easily susceptible of manipulation. However, the same does not seem to be true with the IR. On the contrary, it appears that a lease's IR could be manipulated merely by changing the URV amount.

Assuming that it will be, in the words of FAS 13, "practicable" for the lessee to learn the implicit rate as computed by the lessor,<sup>57</sup> such IR will be used to calculate the PV as long

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<sup>57</sup>Determining the implicit rate requires only that the lessee know the amount of its lease payments, the amount of the executory costs related to the leased property, and the property's estimated residual value at the lease termination. Only this last element would present any difficulty for the lessee to obtain.

Nevertheless, since none of these amounts are privileged or otherwise unattainable to the lessee, it would appear easily feasible for the lessee to obtain this rate under ordinary situations. This would be especially true in circumstances where the lessee and lessor are attempting to work together such that both benefit from the end result.

In this regard, it should be noted that FAS 13 does not prevent a lease from properly being classified both as an operating lease by the lessee while it is classified as a capital lease by the lessor--totally different rules apply to the classification by each party. Just as a lessee ordinarily might want the operating lease classification for greater allowability, a lessor ordinarily will want it classified as a capital lease so as to recognize income at the inception of the lease.

as that rate is less. As noted previously, the IR will be significantly lower where there is a high URV or MLP attributed to the leased property. Since FAS 13 states that the unguaranteed residual value of leased property excludes only that part which is guaranteed by the lessee or a third party related to it, or by one unrelated to the lessor, the Standard thereby seems to permit a lessee to purchase or otherwise obtain a guarantee of residual value from a guarantor that is related in some way to the lessor.<sup>58</sup> Accordingly, a lessee would seem to be permitted by FAS 13 to obtain a residual value guarantee that indicates the residual value of the property is substantially higher than it really is.

FAS 13 thus can be seen to offer lessees a means to ensure that the present value of its minimum lease payments will not exceed the 90% criterion--by authorizing the purchase of a residual value guarantee from a third party related to the lessor. A lessee legitimately will be able to see to it that the lease will be classified as an operating lease, and all its reasonable costs incurred thereunder will be allowed by the Government.<sup>59</sup> Such could even comprise

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<sup>58</sup>Additionally, as provided in a footnote to FAS 13 paragraph 5(I), which footnote is explained in this analysis in note 42, *supra*, FAS 13 expressly provides that a guarantee of residual value made by a guarantor related to the lessor is considered as unguaranteed, at least as far as the lessee is concerned.

<sup>59</sup>In FASB Interpretation No. 19, entitled "Lessee Guarantee of the Residual Value of Leased Property; an interpretation of FASB Statement No. 13," dated October 1977, the FASB clarified the impact a lessee guarantee of residual value of leased property has on the amount of minimum lease payments.

Specifically, the FAS Board responded to a question regarding a lease provision obligating a lessee to make up a deficiency in the lessor's realization of the residual value. In doing so, the FASB held only that a guarantee of residual value obtained by the lessee from a third party bearing no relation to it and which guarantee is for the benefit of the lessor, does not reduce the amount of the lessee's minimum lease payments under FAS 13 paragraph 5(j)(1)(b). At the same time, the consideration which the lessee would have to pay to obtain such a guarantee by an unrelated third party, the FASB noted, would itself constitute an executory cost, which likewise would not be included in the lessee's minimum lease payments

part of the lease bargain reached between the lessee and lessor; in return for a party related to the lessor guaranteeing the residual value of the leased property at an amount that is substantially greater than the value it otherwise would be as of the date of lease termination, the lessee could agree to pay a rental amount that is proportionately that much greater.<sup>60</sup>

The arrangement described above can be understood more easily if applied to the situation of Contractor A. Without changing the \$1,000,000 FMV of the property at lease

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amount.

As noted in the introductory material in Chapter I, *supra*, when the FASB issued an integrated revision of its Statement No. 13 in May 1980, it incorporated this and several other of its previously-issued Interpretations and previous amendments to this and other relevant Statements.

<sup>60</sup>There are potential infirmities to such potential arrangement of fashioning a bargain with terms of this nature the author has determined which might prevent a contractor from taking advantage of such a "loophole."

First, there may be ethical rules similar to those applying to real estate appraisers which would prevent entities from guaranteeing a property's residual value at more than its *bona fide* value. This could represent a false statement. Another possible infirmity is that the lease amounts under even a capital lease still could be found unreasonable, with the excessive amounts disallowed.

If only the latter infirmity prevents such a scheme from being permissible, given the difficulty the Government would have in prevailing on that sole basis, it would seem there is little reason for contractors not to try this.

The FASB appears never yet to have addressed this aspect of such a potential problem. Paragraphs 17(d), 18(d) and 46 of Statement 13 require the lessor to review annually the estimated residual value of sales-type leases, direct financing leases, and leveraged leases, respectively, each of which contains a provision that prohibits any upward *adjustment* of the estimated residual value--not any initial overstatement of the value.

In FASB Technical Bulletin No. 79-14, dated December 28, 1979, the Financial Accounting Standards Board of the Financial Accounting Foundation stated that the prohibition against upward *adjustments* of estimated residual values in Statement 13 also apply to upward adjustments that result from *renegotiations* of the guaranteed portions of residual values.

The instant potential misuse of FAS 13 by lessees thus seems yet to have been addressed by the FASB, however.



inception, the facts show instead that the contractor and its lessor have agreed to a monthly rental amount of \$100,000. Over the term of the lease, Contractor A will pay out a total of \$6,000,000 in lease payments (MLP). With the lessee's incremental borrowing rate (LBR) of 15%, the present value (PV) of those payments would equal \$900,000, which is equal to 90% of the value of the property at lease inception. Using the LBR to determine the PV would therefore cause the lease to be classified as capital, with the result that the contractor's allowable lease costs would be restricted to the costs of ownership.

However, the result would be different if the lease's IR were calculated at a lesser rate than the LBR. Under the  $IR(URV + MLP) = FMV$  formula previously recited, to achieve such a lower rate, the parties would have to come up with a URV which, when added to the \$6,000,000 MLP amount, will equal the property's \$1,000,000 FMV. If the parties agreed to have a party related to the lessor provide a residual value guarantee of \$1,000,000, the IR would calculate out to  $1/7$ , or approximately 14.28%, since  $IR(\$1,000,000 + \$6,000,000) = \$1,000,000$ ;  $IR = \$1,000,000/\$7,000,000$ . The IR would be less than the LBR, so it would apply. Multiplying the IR by the MLP  $(.1428)(\$6,000,000)$  produces a PV of approximately \$857,200, which is less than the 90% of the FMV (\$900,000), with the result that the lease would be classified as operating. The lease costs would then be subjected only to the reasonableness requirement, and likely would withstand challenge.

There is an incentive inherent in FAS 13 for contractors to work with or manipulate figures to prevent lease classification as capital that is abundantly clear; Government practitioners therefore must be vigilant to potential classification manipulation arrangements which might be used to pass on higher costs to the Government. As presently written, that

means paying particular attention to operating leases with payments approaching the 90% criterion to ensure that all costs are reasonable, according to the FAR 31.205-36(b)(1) factors.

### C. CONCLUSION

The fundamental concept underlying the distinction between operating and capital leases, as those terms are used in the FAR cost principles, clearly accepts the definitions, the reasoning, and the view of the Financial Accounting Standards Board as set forth in detail in its Standard No. 13. This begins with the fundamental proposition that unless certain qualifying circumstances and conditions are present, leases of property, plant or equipment by Government contractors are presumed to be operating leases. So long as such costs are reasonable, the costs incurred by contractors under such leases will be allowed and reimbursed.

However, a lease that transfers substantially all of the benefits and risks incident to the ownership of property to a Government contractor will overcome that presumption, and be classified as a capital lease, accounted for as an acquisition. If a lease transfers substantially all of the benefits and risks of ownership of the property to the lessee, its economic effect is similar, in many respects, to that of an installment purchase, and so the cost principles direct

that the cost allowability be treated as such. The costs incurred by the contractor under such lease will be limited to what it would be allowed as though the property were in fact being purchased.

If any of the four basic criteria set out in FAS 13 paragraph 7 are present, a lease will be classified as a capital one and its costs so limited. Unfortunately, although relatively straightforward as previously discussed, the classification of a particular lease agreement under a specific set of facts and circumstances may not always be so certain or obvious, and this uncertainty can lead to significant misunderstanding, abuse or misuse. It must be remembered that lease costs must always be reasonable, no matter how a lease may be classified. As long as the FAS classification criteria are understood and followed, and all practitioners keep in mind that costs must always be reasonable, the uncertainty need not be crippling.

The foregoing analysis is not meant to constitute an indictment on Government contractors. It is not accurate to presume that any engage in any illegal or improper activity, nor that they will do so in the future. Neither is this analysis meant to imply that Government contractors are, as a class, any different from any others in how they conduct business. Rather, the analysis is meant to point out some ways in which accounting requirements and especially lease or rental agreement classification can be misunderstood, and how they ultimately could be misused or abused. If the various rules are not used in the ways in which they were and are intended, whether that misuse is intentional or not, the elaborate system of cost allowability that has been devised to cover all different circumstances, is a failure. That is the outcome that the practitioner must seek to avoid.

If the practitioner grasps the basic concepts established by the FAS 13 provisions, and understands a few general principles and relationships between the various factors which are found in most leases, understanding and working with contractor leases and their costs needn't be so difficult. Until the cost principles, the Financial Accounting Standards, and their theoretical and logical bases are understood, however, contractor costs in this area will remain an unnecessary area of potential dispute and opportunity unrealized.

### III. THE SALE-LEASEBACK SCENARIO

A second issue given special treatment under federal acquisition rules that deserves enhanced attention in this analysis of Government contractor lease and rental costs issues involves the sale-leaseback arrangement. In its most basic form, this is the lease relationship formed when a contractor sells property or facilities that it owns, while at the same time entering into an agreement with the purchaser by which it will lease that same property back from the purchaser. Analysis will reveal, however, that there is ordinarily much more to the transaction than that.

The relevant portions of the cost principles which apply to such arrangements in operating lease circumstances provide, first in FAR 31.205-36:

(b) The following costs are allowable:

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(2) Rental costs under a sale and leaseback arrangement only up to the amount the contractor would be allowed if the contractor retained title.

Sale-leaseback arrangements in capital leases are treated the same way pursuant to FAR 31.205-11(m), wherein it is provided that:

(1) Rental costs under a sale and leaseback arrangement shall be allowable up to the amount that would have been allowed had the contractor retained title to the property.

These guidelines provide essentially that contractor costs incurred in situations

involving sale-leaseback arrangements will be limited much the same as though the properties continued to be held under capital leases or operating leases<sup>62</sup> where the parties are under common control;<sup>63</sup> that is, allowable costs will be limited to those that would be allowed if the contractor had continued to own the leased property outright and continued to depreciate it under the same basis.<sup>64</sup> The result is that the terms of the lease, and the rental amount charged thereunder, will have no bearing on the amount that will be allowed and for which the lessee will be reimbursed by the Government.

#### A. THE REASONS FOR LIMITING SALE-LEASEBACK COSTS

The wording of the cost limitations make it appear as though the special treatment that is given lease costs incurred under sale-leaseback arrangements might be intended to prevent contractors from taking advantage of the greater cost allowability obtaining under operating leases. The potential harm sought to be avoided if such were the intent would be to keep a contractor from purchasing a property it intended to occupy, but instead of merely

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<sup>62</sup>The operating lease/capital lease distinction, and the differing allowability of rental costs between the two, is discussed in detail in Chapter II, *supra*.

<sup>63</sup>Leases between entities found to be under common control, as that concept has been developed for purposes of the allowability of the costs incurred thereunder by Government contractors, is discussed in Chapter IV, *infra*.

<sup>64</sup>For a more detailed discussion of what costs are allowed with respect to owned property, see Chapter V.C, *supra*.

capitalizing the purchase price and charging ownership costs to the Government, it would sell the property to another entity and lease it back. Such an arrangement could permit a contractor to sell property at an amount in excess of its fair market value, while simultaneously entering into an agreement with the purchaser to lease it back under an operating lease at an amount which exceeded fair rental. As long as the amount of the contractor's rental costs were not so excessive as to fail under the general FAR reasonableness standard,<sup>65</sup> not only could the contractor thereby be getting more than the full return on its investment in the property, but the lessor could be getting more than the fair rental for the property, and the Government would be stuck with paying the increased rental amounts.

Notwithstanding the relative simplicity behind such interpretation, prior decisions and the history of the applicable regulatory provisions reveal that such is not at all the potential misuse that the FAR provisions or its predecessors were promulgated to prevent. Rather, the results sought to be achieved by the sale-leaseback restriction are more complex than that, and have changed over time. The Armed Services Board of Contract Appeals in *LTV Aerospace Corporation*,<sup>66</sup> traced in detail the history of earlier versions of the lease and rental cost principles, including the purpose behind the treatment intended by the original ASPR Committee as revealed through its general statements of purpose. After going fully through such detailed analysis, the Board observed:

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<sup>65</sup>See FAR 31.201-2, Determining allowability, and FAR 31.201-3, Determining reasonableness.

<sup>66</sup>ASBCA 17130, 76-1 BCA ¶ 11,840.

"We have found that the term sale and leaseback was first used in the real estate business to describe the sale of an existing, depreciated, but still valuable property, and leasing it back to the former owner as a part of the same transaction. This had a number of advantages to the industrial owner. Often the sale was at a profit, taxed only as a long-term capital gain. The sale converted a fixed asset into cash for use in the furtherance of the business, thus was a means of raising capital. And the entire rental costs were tax deductible.

It was for a sale and leaseback of this nature that ASPR 15-205.34(c) was specifically designed. The 'evil' sought to be prevented was a voluntary action by the contractor in disposing of a used plant facility in a type of transaction which would increase the costs of the Government. The advantages to the seller-lessee were, if he was a Government contractor, disadvantages to the Government. The Government had already reimbursed the contractor for all or part of the depreciation. Rentals based on full value, if allowable, would mean that the Government would pay for the building again. Moreover, in the rentals, it would be paying for the costs of raising capital, which was contrary to the philosophy and intent of the ASPR cost principles. Thus, following this type of sale and leaseback, allowability of rental costs was limited to the normal costs of ownership, which would exclude the interest, risk and profit elements in those rents. Of course, the same interest, risk, and profit elements were allowable in the rent payments under an arms-length lease of property which the contractor had not sold and leased back; thus, obviously 'double depreciation' was the principal target of the sale and leaseback provision.

Later the avoidance of reimbursement for interest in any form, hidden or otherwise, became a major target of the General Accounting Office and the comptroller and accounting agencies of the Department of Defense. The ASPR Committee changed the leasing provisions of the cost principles to limit generally the allowability of long-term lease payments to the costs of ownership."<sup>67</sup>

The analysis set forth in the *LTV* decision, therefore, reveals that when it was originally promulgated, the sale-leaseback limitation was intended to accomplish two separate goals: the first was to prevent the contractor from raising capital at the expense of the

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<sup>67</sup>*Id.*, at 56,627-56,628.



Government by having the Government pay twice for the same property--that is, by first reimbursing a contractor for its property depreciation and other ownership costs, then a second time by reimbursing rental costs to a lessee of the same property which would include paying once again for the lessor's ownership costs.<sup>68</sup> Secondly, the cost limitation generally was intended to save the Government from paying for costs of the contractor/lessee raising capital by selling property which it owned and used and passing through to the Government such costs in the form of rental costs, which the Board deemed to be contrary to the philosophy and intent for which the cost principles had been promulgated.<sup>69</sup>

Although not applicable to the case before it, the Board in *LTV* noted that since the sale-leaseback allowability restriction originally had been drafted, a further use of the restriction had been developed and added.<sup>70</sup> That additional "evil" which the Government

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<sup>68</sup>The *LTV* opinion points out at 56,624 that the sale-leaseback limitation in the 15 May 1953 proposed revision of the ASPR cost principle had been triggered by a situation where a Government contractor, Convair, the previous year had accomplished just that, and by the fact that such transactions were then a topic of widespread publicity.

<sup>69</sup>As noted in *LTV*, after the ASPR Committee began work in 1953 to revise the cost principle, its subcommittee summarized its position regarding sale-leaseback agreements as being that they were primarily entered into to provide a corporate contractor with additional working capital without having to borrow money or issue additional capital stock; possibly to obtain tax benefits; and potentially as a way to recover interest. *Id.*, at 56,625.

This concern about raising capital is the same as that previously described as the "obvious" reason for the limitation. By permitting a contractor to sell and then lease back at full reimbursement of its rental charges a facility or property for which it otherwise would only be entitled to recover ownership costs, it will thereby have raised capital by being given full payment for, and full recovery of, its investment.

<sup>70</sup>The *LTV* Board, while tracing the historical development of the sale-leaseback provisions to the date the decision was announced, decided that only the first two primary objectives of the limitation applied to the controversy before it since this latter purpose had not been intended, nor grafted onto the provisions by amendment, until after the transaction under consideration in that case had taken place. *Id.*, at 56,626.

now also sought to protect against was Government reimbursement of interest costs.<sup>71</sup> The cost principles which apply to lease and rental costs as they are currently drafted refer only to interest costs as unallowable costs of ownership, as already provided in FAR 31.205-20.<sup>72</sup> Therefore, it is for the purpose of saving the Government from the two evils previously mentioned, from paying twice for the same thing and from assisting contractors in raising capital by selling property then leasing it back, that constitute the focus of the sale-leaseback limitation and of this analysis.

### 1. The Duplication of Government Payments.

Preventing the Government from paying more than once for the same thing is quite

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<sup>71</sup>The LTV Board concluded at 56,626 that it was not until the 1969 and later versions of the applicable cost principles "that the exclusion of interest became an active factor in determining allowability of rentals." The 1969 revision imposed a "least cost to the Government" limitation on rental cost allowability which differentiated between long-term and short-term leases.

Ultimately, revisions to FAS 13 that were incorporated into the Defense Acquisition Regulations (DAR) caused such "least cost" limitation to disappear in favor of the present operating/capital lease distinction (see Chapter II, *supra*). Nevertheless, the "least cost" limitation still expressly appears in FAR 31.205-2, the cost principle applicable to ADPE leasing costs (see Chapter V.A, *infra*), and may sometimes be used by auditors or Government official when questioning what they deem to be excessive or unreasonable rental costs.

Presently, FAR 31.205-20 makes interest and certain enumerated financial costs unallowable. This cost principle makes no mention of, nor reference to, lease or rental cost allowability.

<sup>72</sup>See, e.g., FAR 31.205-36(b)(2) (relating to common control situations, discussed in Chapter IV, *infra*), and FAR 31.205-2(b)(4) and (c)(3) (relating to ADPE rentals, discussed in Chapter V.A, *infra*).

reasonable, and not an unusual limitation on cost allowability.<sup>73</sup> The duplicative payment or reimbursement would come about first through a contractor's ownership of property or a facility and charging of its ownership costs (depreciation, *etc.*) to the Government as properly allowable costs. However, once the property has been depreciated and that amount reimbursed by the Government, the Government will have paid for some part of the property (although the contractor of course will continue to be its owner). Once a property has been fully depreciated with such costs reimbursed by the Government, the contractor may be reimbursed only a "use charge" for the property (which may be negotiated with the appropriate Government contracting officer in an advance agreement pursuant to FAR 31.109), but will be substantially less than what it previously received in depreciation costs.<sup>74</sup> All this will occur as long as the property continues to be owned by the contractor or any entity with which it is considered to be "under common control."<sup>75</sup>

The limitation therefore is expressly applicable only where a contractor, or some entity

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<sup>73</sup>See, *e.g.*, Chapter IV, *infra*, where this is analyzed as the intended purpose behind the limitation placed on rental cost allowability in common control situations.

<sup>74</sup>FAR 31.205-11 Depreciation, provides, in pertinent part:

(I) No depreciation or rental shall be allowed on property fully depreciated by the contractor or by any division, subsidiary, or affiliate of the contractor under common control. However, a reasonable charge for using fully depreciated property may be agreed upon and allowed (but see 31.109(h)(2)). In determining the charge, consideration shall be given to cost, total estimated useful life at the time of negotiations, effect of any increased maintenance charges or decreased efficiency due to age, and the amount of depreciation previously charged to Government contracts or subcontracts.

<sup>75</sup>What is meant by a contractor and another entity being "under common control" in the context of lease and rental cost allowability is discussed in greater detail in Chapter IV, *infra*.

with which it shares common control, continues to own property which such contractor had previously owned.<sup>76</sup> Analysis of the cost principles as well as the reported decisions reveals that it does not require that the property already have been *fully* depreciated, but only that the Government have previously reimbursed at least *some* of the ownership costs.<sup>77</sup> Accordingly, if the property is not required to be treated as though the contractor had continued to own it (*i.e.*, with the same basis and depreciation method), at least to some degree the Government thereby will be duplicating costs it previously paid on the same property.

The discussion in *LTV* reveals that the original version of the sale-leaseback provision limited cost allowability because through this duplication of payments the Government essentially was paying in to the contractor's working capital. If the Government were forced to pay rental costs of property for which it already had paid depreciation costs, it was assisting the contractor to raise capital to the extent that the depreciated value of the property

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<sup>76</sup>In *HRB-Singer, Inc.*, ASBCA 10799, 66-2 BCA ¶ 5903, the Board held at 27,383 that, even though the contractor had previously owned real estate which it sold, then leased back after buildings had been constructed on it, there was no sale-leaseback as contemplated by the cost principle. The Board instead deemed the situation to constitute a "build-lease" arrangement. See Section III.B, *infra*.

The reasoning of the ASBCA was that since the relative value of the land compared to the value of the buildings the contractor leased back was immaterial and that no "plant facility" as required by the applicable ASPR cost principle existed until those buildings had been constructed, the limitation was inapplicable. When cited years later in *Talley Defense Systems, Inc.*, ASBCA 39878, 93-1 BCA ¶ 25,521, the Board inferred at 127,157 that *HRB-Singer* might have been wrongly decided.

<sup>77</sup>Since the rental amount charged the contractor will be based on the property's full value (that is, the lessor's basis in the property which presumably will be its purchase price or fair market value as of the purchase date, rather than the contractor's adjusted or depreciated basis), the rental charges will include payment for depreciation of the property from the new owner/lessor's basis in the property (the rental base).

had been recaptured by the contractor when the property had been sold.

## 2. Assisting Contractors in Otherwise Gaining Working Capital at the Government's Expense.

The second evil which the sale-leaseback limitation was intended to guard against was that of the contractor being permitted to raise capital at the expense of the Government by means of providing the contractor with working capital from selling property it owns, but then leasing back that same property. Although preventing Government payment of double depreciation for the property may have been stated in *LTV* to be the "principal target of the sale and leaseback provision," this second purpose is equally valid and binding.<sup>78</sup> Naturally, of course, this latter intended goal sought to be achieved by the limitation has been the subject of considerable disagreement and debate as to whether such a limitation is proper or fair to the contractor.

As observed by the Board in *LTV*, when the ASPR revision proposing the sale-leaseback limitation was initially proposed, it was met with widespread disagreement by industry. Quoted from the responsible ASPR subcommittee's report of 1 November 1955, was the following summary of the position of industry to the limitation:

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<sup>78</sup>*LTV Aerospace Corporation, supra*, at 56,628; see also *Talley Defense Systems, Inc.* ASBCA 39878, 93-1 BCA ¶ 25,521 at 127,157.

"The restriction on amounts of allowable rent for facilities covered by sale and lease-back agreements is not equitable. As long as the rents are reasonable in the light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement the Government's interests are adequately protected. In addition, the Government would be penalizing companies who have sale and lease-back agreements as contrasted with companies holding conventional leases."<sup>79</sup>

While industry objection continued along similar lines through a series of Government-industry discussions on the subject as the cost principles were drafted and promulgated, the Government's consistent response was that limiting allowable costs under sale-leaseback agreements removed contractors' incentive to increase the Government's costs.<sup>80</sup> It was ultimately stated that assisting contractors with raising capital by reimbursing rental costs for properties they had sold "to deliberately increase the costs of the government...for the purpose of raising working capital" was contrary to the philosophy and intent of the cost principles.<sup>81</sup>

*LTV* actually could lead one to the conclusion that this latter justification for the limitation was not intended as an alternative or secondary basis for disallowing the depreciation costs the Government already paid, but rather to disallow only the "normal costs of securing capital such as interest, lender's risk, etc." where a contractor has *deliberately* increased the costs of the government for the purpose of raising capital.<sup>82</sup> Such holding thus

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<sup>79</sup>*LTV Aerospace, supra*, at 56,625.

<sup>80</sup>*Id.*

<sup>81</sup>*Id.*, at 56,628.

<sup>82</sup>*Id.*, at 56,629.

raises a number of interesting issues. Among these are what would be required to establish a deliberate, as opposed to an unintentional or incidental, increase in the costs of the Government, and whether such could be overcome with a showing that the contractor's purpose in executing a sale-leaseback agreement was other than to raise capital at the Government's expense. Since the limitation is absolute and does not distinguish among motivations underlying sale-leaseback transactions, whether this interpretation is correct might present an interesting subject for debate, but subsequent opinions have not elaborated on this.<sup>83</sup>

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<sup>83</sup> Actually, *LTV, supra*, was decided at the same time and by the same division as *Advanced Technology Center*, ASBCA 17131, 76-1 BCA ¶ 11,840, and the decision in *Control Data Corporation*, ASBCA 16448, 76-1 BCA ¶ 11,841 which sustained a contractor's appeal that had been denied twice previously. In all three of these 1976 opinions the ASBCA ruled that the sale-leaseback limitations were inapplicable essentially because the version of the cost principle applicable to the transactions before the Board deemed interest cost components in leases unallowable only if such had resulted in increased costs because a sale-leaseback had occurred.

The Board held that the cost principle which made interest costs unallowable was to be read with the lease and rental cost principle only to define the normal costs of ownership once a sale and leaseback has occurred, and not to help define the nature of the sale-leaseback arrangement that the cost principle was intended to prohibit. Therefore, even though the facts showed sale-leaseback arrangements between entities under common control, the Board ruled that the cost limitations did not apply because neither of the purposes of the limitation (discussed above) were present.

The Board in *Talley Defense Systems, supra*, found the existence of a sale-leaseback under the facts before it strictly under this second basis. In doing so, it merely concluded that the sale-leaseback transaction had resulted in significantly increased cost to the Government.

## B. DISTINGUISHING BUILD-LEASE ARRANGEMENTS

A circumstance bearing great similarity to the sale-leaseback arrangement, but which does not provide the same cost allowability limitation, is the "build-lease" agreement. Such concept has been developed by case law as a device essentially wherein a contractor which holds title to undeveloped real property agrees to sell to another party. As a part of that agreement, or simultaneously with it, the vendee agrees to construct a facility on that property which the contractor agrees that it will lease back.<sup>84</sup>

*Talley Defense Systems, Inc.*, *supra*, and *Educational Computer Corporation*, ASBCA 20749, 78-1 BCA ¶ 13,111 are the only reported decisions to date where a sale-leaseback arrangement, as that transaction is envisioned under the cost principles, has been found to have been established.<sup>85</sup> These decisions reason that the single factor which will determine the true nature of the arrangement is the contractor's motivation behind entering

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<sup>84</sup>See, e.g., *HRB-Singer*, *supra*, and *LTV*, *supra*.

<sup>85</sup>*Educational Computer*, despite finding the existence of a sale-leaseback arrangement, actually appears to have little application to the typical contractor lease/rental situation. In the unusual facts of that case the Board determined, *sua sponte*, that a sale-leaseback was the most accurate way to characterize what the Government and contractor, respectively, previously had referred to as an assignment and a licensing agreement.

Nevertheless, consistent with the analysis in *Talley Defense Systems*, the primary basis for the Board finding a sale-leaseback transaction was that the contractor's primary motivation underlying the transaction was to raise capital. Unfortunately, however, since such holding seems narrowly limited to the peculiar facts there presented, it seems unlikely that such determination will carry any significant precedential weight in the typical contractor rental situation.



into the transaction--if that purpose was to obtain capital at the Government's expense, the arrangement will be deemed to be a sale-leaseback within the subject limitation.<sup>86</sup> *Ergo*, there is no sale-leaseback if the contractor's motivation behind the transaction was merely to enable it to finance obtaining plant facilities without having to invest contractor money (rather than to *obtain* capital), or if there is sufficient proof the transaction was at arms's length.<sup>87</sup> However, in *Talley Defense Systems*, the cost differential between ownership and leasing were so great that the Board hinted that the lease costs might have been unreasonable.<sup>88</sup>

Although neither *Talley Defense Systems* nor *Educational Computer* goes on to distinguish the findings of no sale-leaseback arrangements in prior holdings on this issue,<sup>89</sup> if the contractor's motivation behind the transaction is solely sufficient to distinguish sale-leaseback transactions from build-lease ones, then *LTV*, *Advanced Technology*, and *Control Data* can likewise be distinguished on that basis. In none of those cases did the Boards find that the arrangements at issue were set up either to obtain capital from duplicative depreciation or to provide the contractor with working capital at the Government's expense. The opinion in *Talley Defense Systems* may thus have formulated a usable criterion for distinguishing between the two arrangements (but the cost difference between them must be great, or the contractor's improper motivation for the arrangement clear).

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<sup>86</sup>See *Talley Defense Systems, Inc.*, *supra*, at 127,157; *Educational Computer Corporation*, *supra*, at 64,077.

<sup>87</sup>*Talley Defense Systems*, *supra*, at 127,157-8, distinguishing *HRB-Singer*, *supra*.

<sup>88</sup>See *Talley Defense Systems, Inc.*, *supra*, at 127,157.

<sup>89</sup>Although *Talley Defense Systems* cites the other cases, it only attempts to distinguish *HRB-Singer*.

## C. CONCLUSION

In reality, it will be indeed rare for a contractor not always to design its actions and all its corporate decisions without the motivation of obtaining or preserving capital. Furthermore, case law shows that the mere fact a contractor may previously have owned property that it intends to lease back does not, without more, mean that the arrangement will constitute a sale-leaseback transaction as that concept has been defined under the applicable cost principles. Finally, neither does the fact that there may be costs in a transaction resembling a sale-leaseback which are higher than the costs of ownership mean that the arrangement will be found to be a sale-leaseback or the cost allowability limited, at least unless the costs are substantially greater.

Rather, it appears as though the single factor which may safely be relied upon to cause a lease arrangement to be considered a sale-leaseback is that the leased premises already have been depreciated with the Government reimbursing a contractor for its ownership costs. If such has occurred, if that property subsequently is transferred to some other entity who then leases it back to the contractor or a related party-contractor at a rental charge based on the full adjusted value of the property, allowability will be limited. Unless all this can be established under any particular facts, or the difference between the rental and ownership costs is gross, the likelihood of limiting allowable costs merely because the Government's costs are higher appears very slim.

## IV. THE COMMON CONTROL CONUNDRUM

The third major limitation placed on Government contractor lease and rental costs, which has proven to be the most frequently litigated source of disagreement within the subject area concerns instances where the contractor and its lessor are "under common control" or "related."<sup>90</sup> How lease costs and their allowability are treated under such circumstances differs significantly, depending upon whether the particular lease at issue is classified as an operating or a capital one.<sup>91</sup> As to operating leases, as that term has been defined under FAS 13, the cost principle at FAR 31.205-36 applies. That cost principle provides, in pertinent part:

(b) The following costs are allowable:

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<sup>90</sup> The former phrase is used by the FAR when referring to operating leases as defined under FAS 13, and the latter is used when there are capital leases. "Control," which is discussed more fully in subparagraph B, *infra*, has been defined by FAS 57 in such a way as to constitute the salient feature present in relations between "related parties" in leasing transactions, as that concept has been defined in paragraph 5(a) of FAS 13.

It appears from case law that the two phrases represent the same concept and are interchangeable, with the implied assumption that where a contractor and its lessor are related they must be under common control.

Although the use of different phrases for the same concept for the different classifications of leases raises an interesting question (whether one perhaps was intended to be more expansive than the other), such has never been addressed in any reported opinions, so that other than raising it for this brief sidelight, the question will not be further addressed in this analysis.

<sup>91</sup>For a detailed analysis of the operating/capital lease distinction and guidelines to assist with making the proper classification, see Chapter II, *supra*.

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(3) Charges in the nature of rent for property between any divisions, subsidiaries, or organization under common control, to the extent that they do not exceed the normal costs of ownership, such as depreciation, taxes, insurance, facilities' capital cost of money, and maintenance (excluding interest or other unallowable costs pursuant to part 31), provided that no part of such costs shall duplicate any other allowed cost. Rental cost of personal property leased from any division, subsidiary, or affiliate of the contractor under common control, that has an established practice of leasing the same or similar property to unaffiliated lessees shall be allowed in accordance with subparagraph (b)(1) above.<sup>92</sup>

With respect to capital leases, the proper treatment is set out in FAR 31.205-11(m)(2), wherein is stated, in pertinent part:

(2) Capital leases, as defined in FAS-13, for all real and personal property, between any related parties are subject to the requirements of this subparagraph 31.205-11(m). If it is determined that the terms of the lease have been significantly affected by the fact that the lessee and lessor are

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<sup>92</sup>This last sentence provides that the common control limitations apply only to leases involving real property or plant facilities. These limitations expressly do *not* apply to rentals of *personal* property between a contractor and a lessor with which it shares common control, *if* the lessor has an established practice of leasing the same or similar property to unaffiliated lessees. If there is such an established practice, subparagraph (b)(1), which governs the basic determination of whether operating lease terms are reasonable, applies. That subparagraph provides:

(1) Rental costs under operating leases, to the extent that the rates are reasonable at the time of the lease decision, after consideration of (i) rental costs of comparable property, if any; (ii) market conditions in the area; (iii) the type, life expectancy, condition, and value of the property leased; (iv) alternatives available; and (v) other provisions of the agreement.

related, depreciation charges shall not be allowed in excess of those which would have occurred if the lease contained terms consistent with those found in a lease between unrelated parties.

The effect of these provisions on a contractor's cost recovery can be substantial. It is fundamental that rental costs incurred by Government contractors, like most other costs incurred in contract performance, ordinarily will be fully allowable, limited only by the reasonableness standard.<sup>93</sup> However, the two cost principles provide significant further restrictions on the allowability of lease costs when a contractor and its lessor are related or under common control.

As to operating leases, FAR 31.205-36 provides that allowable operating lease or rental costs are subjected to two additional limitations in instances where there is common control. The first is that the costs which will be allowed may not exceed the normal costs of ownership, of which a number of specific examples of ownership costs which are typically

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<sup>93</sup>As indicated in the previous note, subparagraph (b)(1) of FAR 31.205-36 essentially directs that the allowability of operating lease costs is a function of whether they are reasonable in comparison with lease amounts for comparable properties for like uses, under like circumstances that were executed at the same time.

Furthermore, FAR 31.201-2, "Determining allowability," and FAR 31.201-3, "Determining reasonableness" provide guidance for analyzing contractor costs *of all types* generally for reasonableness and allowability under FAR. The former essentially provides that no cost will be allowable unless it is reasonable, allocable and allowable under the terms of the contract and cost principles. The latter provides that a cost is reasonable if it does not exceed what a "prudent person in the conduct of a competitive business" would incur, and lists four nonexclusive considerations to aid in the determination.

So long as the cost is properly allocable to the Government contract(s) involved, and is not made unallowable by some FAR Part 31 cost principle or contract term, it will be reimbursable to the contractor unless it exceeds that which a prudent businessperson would have incurred at the time under like circumstances (*i.e.*, is not reasonable).

See also generally Chapter V.C, *infra*.

allowed (*i.e.*, depreciation, taxes, insurance, facilities capital cost of money, and maintenance) are listed (see chapter V.C, *infra*). The second limitation is that costs in the nature of rent may not "duplicate" any other costs which are allowed.

With respect to capital leases, FAR 31.205-11(m) provides that lease agreements which contain terms that are "significantly affected" by the fact that the lessee and lessor are related will undergo further limitation on cost allowability. *Viz*, the allowable depreciation cost cannot exceed the depreciation which would be imputed constructively to the leased property, limited to that amount which would have occurred had the lease contained terms consistent with those that would be found in a lease between unrelated parties. This essentially limits allowability of the amounts a contractor has paid under a capital lease to that which would have been allowed in depreciation had the contractor owned the leased property; if the lease contains terms which were significantly affected by the fact that the lessee and the lessor are related, such terms will be deleted from the lease so as to leave it with only those that would have been in the lease if the parties were not related.

The language of FAR 31.205-11(m) is potentially ambiguous, and could be interpreted to provide that the limitation applicable to capital leases between related parties greatly reduces the allowable costs only to recovery of depreciation costs. Unfortunately there are no reported cases that have interpreted the cited limitation in capital lease situations, so it remains to be seen precisely how it would be judicially interpreted. Nevertheless, as explained below, the application of fundamental principles developed to deal with statutory/regulatory construction leads to the conclusion that the limitation may not be as expansive as the above reading might imply.

First, reading the provision as limiting allowability solely to depreciation without allowing the otherwise allowable costs of ownership unquestionably "would lead to irreconcilable disparities in recovery for identical items"<sup>94</sup> between what it would cost for a contractor to lease from a related party compared with an unrelated one. Such disparate treatment is arbitrary and unreasonable, and cases have directed that such interpretation should be avoided if at all possible.<sup>95</sup>

Second, policy considerations require that regulations be interpreted to effect their underlying legislative or regulatory purpose.<sup>96</sup> Interpreting the cost principle as only permitting the contractor to recover its depreciation costs would lead to an unfavorable price for the Government should the contractor choose simply to avoid the issue by renting a more expensive item from an unrelated party. That surely could not have been the purpose behind the limitation, so it must be assumed that such interpretation would not be followed. Certainly such interpretation could not have been what was intended when the cost principle was drafted.

With respect to operating leases between parties under common control, on the other hand, there has been substantial litigation and interpretive analysis, and it is upon those limitations and their meaning that this chapter will focus.

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<sup>94</sup>*Engineering, Incorporated*, NASA BCA 187-2, 88-2 BCA ¶ 20, 792, at 105,041.

<sup>95</sup>See, e.g., *Trustee of Indiana University v. United States*, 233 Ct. Cl. 88, 618 F.2d 736(1980), at p. 94, 739.

<sup>96</sup>See, e.g., *Richards v. United States*, 569 U.S. 1, 11 (1962).

## A. THE REASON FOR THE LIMITATION

Before looking at what may or may not constitute common control under particular circumstances presented, it is necessary to understand conceptually the rationale behind why special treatment is accorded leases between entities which happen to share common control. The fact that a contractor and its landlord or the lessor of its equipment are commonly controlled naturally will tend to raise suspicions that the rental amounts may be excessive or unreasonable simply because there is a transaction at less than arm's length. However, a review of previous decisions, as well as the specific wording of the cost principle, makes it clear that unreasonableness is a concern which is distinct from the harm that was sought to be protected against by FAR 31.205-36 (b)(3) and its predecessors.

As previously discussed in notes 92 and 93, the reasonableness of the amounts paid for a leasehold or its related terms is addressed in other provisions of the FAR. In fact, FAR 31.201-3 expressly lists the lack of arms length bargaining as an element in determining whether costs sought to be charged by contractors are unreasonable. Further, all rental costs that are excessive and unreasonable will not be allowed under the FAR provisions, regardless of whether the contractor and its lessor are commonly controlled.<sup>97</sup> Stated otherwise, a finding of common control is not required in order for the excessive and unreasonable portion of a contractor's lease or rental costs to be disallowed.

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<sup>97</sup>See notes 92 and 93, *supra*, and FAR 31.201-2 and FAR 31.201-3.



Under the rationale behind the cost principle as observed in case law, costs are subjected to limitations on allowability because the common control can result in the Government paying out duplicative costs.<sup>98</sup> Therefore, the costs that will be allowed by the Government are subject to further limitation because the common control will result in the Government paying out more than once for the same type of costs.

A contractor's allowable costs, including its lease and rental costs, are burdened with proportional shares of additional costs which include profit at the rate provided for under the contract. When the Government reimburses a contractor for its rental costs, therefore, it also is paying the contractor the maximum profit on them and the contractor's other costs that is authorized under the terms of the contract. At the same time, the entity which owns the facility or property which is being leased is receiving its full lease payments, which include profit in the form of a return on the ownership investment.<sup>99</sup>

In theory, then, when an entity has control over both the contractor and its related owner of the leased facility or equipment, this ultimately means that such entity is receiving both the profit that is built into the rental amount charged, as well as the profit allowed the contractor under the terms of the contract. This makes for pyramiding or the duplication of costs, which the cost principles prohibit and against which they are obviously intended to guard. It is thus the Government's having to pay the additional costs which arise from the

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<sup>98</sup>See, e.g., *West Tool & Manufacturing, Inc.*, NASA BCA 53-0891, 93-2 BCA ¶ 25,763; *A.S. Thomas, Inc.*, ASBCA 10745, 66-1 BCA 5438; *Mauch Laboratories, Inc.*, ASBCA 8559, 1964 BCA ¶ 4023.

<sup>99</sup>See, e.g., *Mauch Laboratories, supra*.

duplication or pyramiding of contractor profits which FAR 31.205-36(b)(3) is meant to prevent.<sup>100</sup>

The DCAA Contract Audit Manual<sup>101</sup> (hereafter, "CAM") addresses the topic of "common control" under the phrase "leases between related parties," covering both operating and capital leases. As to the former, the CAM states that the costs of operating leases between related parties are generally allowable to the extent they do not exceed normal costs of ownership, adding "(excluding interest or other costs unallowable and including cost of money)."<sup>102</sup> As to capital leases, it basically restates what is provided in FAR 31.205-11(m)(2), adding that the reasonableness of lease payments should be determined by comparing the "present value"<sup>103</sup> of the lease payments with the fair market value of the leased property, according to the provisions of FAS 13.

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<sup>100</sup>*West Tool & Manufacturing, Inc.*, *supra*, at 128,195.

<sup>101</sup>DCAAM 7640.1

<sup>102</sup>CAM 7-207.2.a. The normal costs of ownership which are allowed, serving as a limitation on allowable rental costs, are discussed in Chapter V.C, *infra*. The parenthetical statement which is added by the CAM provision relating to the cost of money does not appear to add anything beyond what is already provided elsewhere in the FAR (see FAR 31.205-10).

It must be presumed that the addition is intended to call special attention to this troublesome and frequently-encountered element of ownership costs which closely resemble unallowable interest costs, but which are instead allowable. It would be instructive to note, however, that *Engineering, Incorporated*, *supra*, provides an interesting discussion authored by Administrative Judge Dicus which analyzes the legal effect of similar language that had been contained in the correlative NASA rental cost principle.

Judge Dicus pointed out that under the doctrine of *ejusdem generis*, the proviso portion of the principle which carves an exception out of the body of the section to which reference is made must be strictly construed, and will not be extended to other than what is plainly and unmistakably within its terms and spirit. See *A.H. Phillips, Inc. v. Walling*, 324 U.S. 490, 493 (1945).

<sup>103</sup>See Chapter II, *supra*.

In what constitutes questionable logic in construing the cost principle, paragraph 7-207.2b(2) of the CAM states that a showing that operating lease costs are unreasonable is an important factor to be considered in making the determination whether a contractor and its lessor are under common control.<sup>104</sup> Such guidance is of questionable validity, and is a somewhat backwards application of the rule in FAR 31.201-3 which alerts contracting officers to situations of common control, where cost reasonableness must be examined with particular care. The CAM's illogical conclusion, that unreasonable lease costs are a factor in determining common control rather than the inverse, raises the concern that the DCAA auditors might simply follow such guidance while remaining blind to the true harm that common control, as provided for in FAR 31.205-36(b)(3), seeks to prevent.

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<sup>104</sup>CAM 7-207.2.b(2) provides, *in toto*:

(2) The existence of unreasonable lease terms may also provide evidence of control. If the lease terms are unreasonable as compared to those available in the competitive market, it may be because one company has exercised significant influence over the operating and financial policies of the joint venture. Reasonableness may be reviewed by comparing the terms of the lease with (a) the contractor's other comparable leases that did not involve a related party, (b) other comparable leases, and (c) actual advertised prices for the facilities in question or other similar facilities. Both the rates (cost per square foot for example) and other terms (such as fixed noncancellable leases versus those with options) must be considered in determining the reasonableness of the lease costs. While showing that the lease costs are unreasonable will not in itself constitute a determination of common control, it is an important factor in making such a determination. In addition, if the government is unable to prevail in its common control argument, it nevertheless should prevail in proving that the lease costs were unreasonable at the time of the lease decision under the provisions of FAR 31.205-36(b)(1).

Logically, the fact that lease or rental amounts are or are not reasonable, and the fact that such amounts may have been paid to an entity sharing common control with a contractor, are facts that do not necessarily bear any relationship. While the existence of excessive operating lease costs substantially greater than those charged for comparable properties might make further investigation into whether there is common control appropriate, common control either exists or it doesn't--such fact does not mean that the rental amount is any more or less reasonable. It follows, then, that notwithstanding what the CAM directs of its auditors, whether or not lease or rental costs/terms under an operating lease are reasonable should not be made into a factor to be considered in determining whether the circumstances support a finding of common control.<sup>105</sup>

## B. CONTROL ISSUES

Beginning even before the promulgation of the first Armed Services Procurement

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<sup>105</sup>CAM 7.207.2.b(2)'s statement that if the Government is unable to prevail in its common control argument it nevertheless should prevail in proving that the rental costs are unreasonable, is therefore similarly misleading, perhaps invalid, and potentially subject to legitimate objection by an audited contractor.

The way the CAM treats common control situations, although as discussed not logically consistent, may still offer practical advantages to the Government when challenging cost allowability. Challenging a contractor's costs solely on the basis of reasonableness, or its absence, is difficult largely because comparable properties frequently do not exist. The two-pronged challenge of common control and unreasonableness seems to offer the Government an alternative or "fall-back" argument. Nevertheless, the fact remains that common control and unreasonableness of costs they are not logically connected.

Regulations (ASPR) of 1947 and years before the cost principles came out in their current form,<sup>106</sup> whether contractors performing contracts with the United States and entities with which they had business dealings are under common control has been a contentious issue.<sup>107</sup> Whether the specific arrangements the contractors have with those other entities supports a finding of common control has continued to be an unsettled area.

The first criterion in determining which costs of a particular lease between parties

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<sup>106</sup>The cost principles were first prepared by Dr. Howard W. Wright while with the ASPR Committee, becoming ASPR Section 15, Part 2 at that early date. The first draft of a 15 May 1953 proposed revision provided in 15-313.06 that rental costs "paid to persons, including corporations, affiliated with the contractor" were not considered to be *bona fide*, so that they were not allowable. See *LTV Aerospace Corporation*, ASBCA 17130, 76-1 BCA 11,840 at 56,623.

<sup>107</sup>The earliest reported case involving Government contracts to address common control was *Lowell Wool By-Products Co. v. War Contracts Price Adjustment Board*, 192 F.2d 405 (D.C. Cir. 1951).

This case arose out of the World War II-era "Renegotiation Act," 50 U.S.C. App. § 1191, which authorized the specially-created War Contracts Price Adjustment Board to renegotiate contracts with contractors having "war contracts" income. Common control was at issue in *Lowell* not because the Renegotiation Act identified transactions between parties commonly controlled as indicating that the Government might be paying out duplicative profits, or even that such raised the possibility of a lack of bargaining at arms-length which might lead to excessive profits, but rather because the Act specifically applied only to contractors having war contracts which exceeded a minimum threshold amount.

Unlike the rental cost principle's stated intent of limiting cost recovery in common control situations, whether the amounts charged in the various transactions between the parties under common control in *Lowell* were duplicative or excessive, *per se*, was irrelevant. Common control was considered simply to determine whether the gross war contracts sales of any contractor should be considered and aggregated with those of a "connected" contractor. Finding that Lowell Wool By-Products Company and the other contractor were under common control gave the Board jurisdiction to renegotiate their war contracts to reduce what it found to have been excessive profits. Such determination of excess was based strictly and solely on statutorily authorized guidelines.

Despite the fact that *Lowell* has been cited in numerous opinions and decisions interpreting the various lease and rental cost principle versions, it is doubtful that a holding and analysis of what constitutes common control for the purpose of aggregating contracts under the Renegotiation Act is, or should be, relevant to this cost allowability limitation.

under common control are allowable depends on how the term "common control" is defined. To the contractor's and practitioner's chagrin, however, nowhere in the current or the previous versions of the regulations is that term defined.<sup>108</sup> Unfortunately, a review of the reported decisions and their reasoning, as well as the guidance provided in the CAM, demonstrates that the various authorities may not always have properly analyzed the circumstances to ensure that the properly anticipated harm would be prevented. The inconsistent analyses which have been made by the various authorities show the difficulty that the cost principles have caused in distinguishing between provisions meant to limit costs due to unreasonableness, and those meant to limit them to prevent duplicative recovery.

The CAM places great weight upon several pronouncements of the Financial Accounting Standards Board, which has defined control as "[t]he possession, direct or indirect, of the power to direct or cause the direction of the management or policies of an enterprise through ownership, by contract, or otherwise."<sup>109</sup> In a number of decisions, such as *Manlabs, Incorporated*,<sup>110</sup> it has been made clear that determining whether organizational entities are subject to common control is a question of fact which hinges on the particular circumstances presented, and that making this determination requires looking to the substance of a relationship over its form.<sup>111</sup> As will become clear below, the broader conclusions and

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<sup>108</sup>See, e.g., *West Tool & Manufacturing, Inc.*, *supra*, at 128,194; *Manlabs, Incorporated*, ASBCA 12389, 69-1 BCA ¶ 7480, at 34,704-5.

<sup>109</sup>Statement of the Financial Accounting Standards Board No. 57 ("FAS 57").

<sup>110</sup>ASBCA 12389, 69-1 BCA ¶ 7480.

<sup>111</sup>*Id.*, at 34,704.

generalizations which can be drawn that relate to this determination are all extremely fact specific.

In the appeal of *Brown Engineering Company, Inc.*,<sup>112</sup> the NASA Board held that common control under the cost principle is established where the contractor owns all the stock of its landlord, shares officers and directors with that corporation, and conducted the business affairs of its subsidiary in such a way as to show that the contractor's interests are being served.<sup>113</sup> While helpful, such guidance is of limited value for future application since it covers only the most obvious situations, where a finding of common control would rarely be disputed.

A more detailed listing of what factors could establish common control covered by the cost principle was set out in *Data-Design Laboratories*.<sup>114</sup> Although the Board found that there was no common control under the facts with which it was presented, it identified a number of factors which could establish under appropriate circumstances common control when dealing with two corporations. These indicators include the degree of control actually possessed by the common entity, as manifested in the presence of such factors as the independence exhibited by the respective boards of directors in the faithfulness of their exercise of their fiduciary duties owed to each corporation's shareholders, the percentage of shared ownership of stock, the degree of identity of membership of the two boards, the public or private nature of the corporations, and the very nature of the "entire leasehold package"

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<sup>112</sup>NASA BCA 31, 1964 BCA ¶ 4101.

<sup>113</sup>*Id.*, at 20,022-3.

<sup>114</sup>ASBCA 26753, 85-1 BCA ¶ 17,825.

itself as well as its terms.<sup>115</sup>

Rejected by the *Data-Design* Board as automatically establishing common control *per se* were the presence of such facts as some minor commonality of shareholders and that the lease agreement is "triple-net."<sup>116</sup> *Data-Design* makes it clear that the ultimate finding of whether the two corporations are commonly controlled must necessarily be one made on a case-by-case basis, and in the final outcome it can only be made after a complete review of the totality of the facts and circumstances.

That the determination cannot be made simply by a *pro forma* application of rigid rules exalting form over substance was again stressed in *Talley Defense Systems, supra*, where the ASBCA reaffirmed that ownership percentages in organizational entities alone was

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<sup>115</sup>*Id.*, at 89,217.

<sup>116</sup>A "triple-net" or "net-net-net" lease is one in which the lessee pays all the expenses including mortgage interest and amortization leaving the lessor with an amount free of all claims. BLACK'S LAW DICTIONARY 801 (5th ed. 1979). As properly analyzed in the *Data-Design* opinion, such a lease absolves the lessor of its risks of investment by making the lessee responsible for payment of taxes, insurance and maintenance.

Nevertheless, the Board stated in *Data-Design* that a triple-net lease did not there constitute "double payment" because the amount paid by the contractor was no different from what it might have paid an unrelated lessor. The Board added that had the lease not been triple net and the lessor responsible for taxes, insurance and maintenance increases, the lease would either have required a higher rental or provided for increases during the leasehold term to reflect such increases.

The Board's reasoning as to the latter points appears questionable. It could be read as providing that the limitation does not apply if the lease amount charged between entities under common control can be shown not to be different from what it would be if they were not so related. Such construction would circumvent the reason behind the limitation and could permit the very pyramiding of profits the cost principle seeks to prevent.

*Data-Design* thus reveals an inescapable flaw in achieving the goals sought by the cost principle. Specifically, double recovery or pyramiding of profits in a single entity will be permitted, so long as that entity does not "control" the contractor and its lessor in the sense focused on by FAS 57, by directing the management or policies of both.



not determinative. Citing to a number of previous decisions, the Board listed several factors it deemed relevant to the determination, including stock ownership, common office-holding and directorship, the transfer of funds between the organizations, contractual relationships, and the manner in which the entities' business affairs were conducted, including whether space or employees were shared.<sup>117</sup> Distinguishing *Data-Design* as based on its facts which showed truly independent management and boards of directors, the Board in *Talley Defense Systems* held that prohibited common control existed where the entities' transactions were shown to have been "taken in concert and apparently intended to achieve a certain goal."<sup>118</sup>

The most recent pronouncement on this determination is contained in *West Tool & Manufacturing, supra*, where the NASA Board stated that a finding of common control under the FAR should depend upon "facts demonstrating direct or indirect control over management and policies of an entity, whether by familial influence, stock ownership, trust instrument, or otherwise, and Government contract cases finding common control also involves [*sic*] additional costs for the Government."<sup>119</sup> Holding that the facts before it did not support a finding that there was any common control, the Board dismissed the point that the circumstances could have caused a double recovery of profit merely by stating that the situation resulted in no "inequity" to NASA.<sup>120</sup>

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<sup>117</sup>*Talley Defense Systems, Inc.*, ASBCA 39879, 93-1 BCA ¶ 25,521 at 127,155.

<sup>118</sup>*Id.*, at 127,156.

<sup>119</sup>*West Tool & Manufacturing, Inc., supra*, at 128,194.

<sup>120</sup>*Id.*, at 128,195. The NASA BCA here seems to have made the same mistake of viewing the common control limitation as being one that addresses reasonableness. For further discussion of this point, see Subsection IV.A, above.

The CAM seems to provide relatively better guidance on this point, noting that “[t]he key question [to address in making a determination of common control in an operating lease situation] is whether or not one party has the ability to exercise control over the operating and financial policies of the related party.”<sup>121</sup> Although the CAM does not go on to identify what then will be necessary for a party to have the ability to “control” the various policies of another, it nevertheless suggests that important areas of audit review for the presence of such control include the parties’ actual decision-making process and the reasonableness of the lease terms.<sup>122</sup> It appears as though the FAS 57 definition quoted above, prepared by accountants with accounting considerations and economic realities in mind, is of as much practical benefit to the Government contracts lawyer as any that can be found. In sum, then, common control will be deemed to exist if the circumstances show that one entity has the power to direct the

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Further rendering the *West Tool* decision suspect is the fact that the support it cites for much of its holding on this point is a federal district court decision which listed factors relevant to a finding of common control for purposes of the Fair Labor Standards Act of 1938. As analyzed in note 107, *supra*, it is most questionable whether finding that common control has been established for such purpose has any relevance where the regulatory/statutory bases and purposes are not the same.

For a more reasoned analysis of this point, see the appeal of *Brown Engineering Company, Inc.*, NASA BCA 31, 1964 BCA ¶ 4101. There, the Board observed at 20,022 that “the mere fact that a rental charge may have been established as ‘reasonable,’ in comparison with prevailing rates and market prices, does not obviate the necessity for its evaluation in light of ASPR 15.205-34(b), nor preclude its disallowance or reduction pursuant to that provision.”

<sup>121</sup>CAM 7-207.2.b.

<sup>122</sup>*Id.* However, as previously observed, including in notes 105 and 106, *supra*, the CAM’s guidance that showing that lease terms are unreasonable is an important factor in making the common control determination, is inconsistent with basing the determination on facts showing that a party is able to exercise control over the policies of another.

management or policies of both the lessee and the lessor.

In light of the confusion and frequent inconsistencies as to how and when the limitation should apply, since the effect of a common control determination can significantly limit a contractor's reasonable and otherwise allowable rental costs, it thus should come as no surprise that the issue has continued to be litigated frequently. Its boundaries have been left to definition by the various boards and courts, which have generally carved out a set of parameters or guidelines for its application. Additionally, however, where common control has been found to exist, the practical question remains as to *how* such fact restricts recovery of costs which would otherwise be entirely reasonable and allowable.

A number of basic concepts necessary for the practitioner's understanding have developed over time, and may generally be broken into a number of legal guidelines. Despite the great confusion engendered by the cost principles as to what the rule should or should not permit, these concepts can prove most beneficial in working with related party or common control situations, and will be analyzed in the subsections which follow, with a view toward assisting the practitioner who is faced with a lease/purchase decision to fight through the morass.

## 1. Common Control Does Not Require Control By a Third Party.

A reasonable reading of the cost principle might seem to indicate that a contractor and its lessor must both be under the control of some parent or other entity in order for the limitation to apply--that the restriction does not apply if one of the parties controls the other. This seems especially true in light of the second sentence of the applicable subparagraph, which refers to "any division, subsidiary, or affiliate of the contractor under common control...." This interpretation was first expressly espoused<sup>123</sup> in a board or judicial opinion in a January 1964 decision, in the dissenting opinion to *Mauch Laboratories, Inc.*<sup>124</sup> However, decisions since that time have proven that this not a requirement for the common control finding to be made.

*Mauch Laboratories* involved a consultant whose services to the Government

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<sup>123</sup>While the *Lowell Wool By-Products* decision, *supra*, is cited as authority in the dissent, *Lowell* appears neither to have addressed this aspect of common control, nor was such critical to its ultimate finding of common control.

The specific corporations involved in *Lowell*, as well as some others not directly involved in the specific appeal, were owned by the same core of three families. However, the further fact that these corporations were controlled by those three family units, as opposed to the corporations owning each other, was not noted as being of any particular significance, nor was it stated to be a condition of the Court's finding that there was common control.

Further, at least one decision predating the dissent in *Mauch Laboratories* seems to have accepted without comment that common control would be satisfied where a corporate parent of a contractor is also the contractor's lessor. However, in that previous decision the Board determined that the ASPR version applicable to the contract and contractor was the one that was in effect before the rental cost principle was formulated and became law. Finding that the lease terms were not unreasonable, the Board ultimately did not address the common ownership question. *Hicks Corporation*, ASBCA 7767, 1962 BCA ¶ 3600.

<sup>124</sup>ASBCA 8559, 1964 BCA ¶ 4023 (William D. McConoughey, dissenting).

outgrew what he was capable of performing literally out of the basement of his home. He therefore ventured into business as an independent contractor and incorporated. With his wife, he acquired a building and equipment and leased them, as well as certain other equipment he already owned and had utilized in performing his previous contracts, to the new corporation. When the contracting officer disallowed a portion of the corporation's rental costs under a cost plus fixed-fee contract it had obtained, the contractor appealed. Holding that the clear purpose of the cost principle<sup>125</sup> is to prevent the Government from having to pay profits both on the costs of the lease as well as on the investment in realty, both of which eventually flow to the entity controlling the contractor, the Board sided with the Government and disallowed the excess rental costs.<sup>126</sup>

While acknowledging these facts, the dissent reasoned that the provision by its express language applies only where a contractor and the owner of its leased facility are "under 'common control' of a third authority."<sup>127</sup> Since there was no such third party where the lessors themselves controlled the contractor, the dissent concluded that the Board was "not

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<sup>125</sup>The cost principle specifically there at issue was ASPR 15-205.34, which was substantially similar to the current FAR provision as to this limitation, providing in relevant part:

(b) Charges in the nature of rent between plants, divisions, or organizations under common control are allowable to the extent such charges do not exceed the normal costs of ownership, such as depreciation, taxes, insurance, and maintenance; provided, that no part of such costs shall duplicate any other allowed costs.

<sup>126</sup>*Mauch Laboratories, Inc.*, *supra*, at 19,804.

<sup>127</sup>*Id.*, (William D. McConoughey, dissenting), at 19,804.

required to regard a lessor and lessee as being under common control."<sup>128</sup> Mr. McConoughey thus reasoned that the cost principle's allowability limitation was not meant to apply.

It was not long before the issue again surfaced. The NASA Board of Contract Appeals was directly confronted with the identical issue just two months later, when a contractor argued that it was not bound by the limitation in the ASPR provision since it and its lessor were not under the common control of any third entity.<sup>129</sup> The NASA Board rejected this position, holding that determining a contractor and its lessor to be under common control and its allowable rental costs recovery subject to the ASPR limitation "was compelled" where the contractor corporation wholly owned the corporation from which it leased the facility in which it performed its Government contract work.<sup>130</sup>

Approximately a year later, the ASBCA decided in *Sanders Associates, Inc.*<sup>131</sup> that the total control a contractor-parent corporation *could* exercise over its wholly-owned subsidiary from which it leased its facility was sufficient to establish common control. (*Emphasis added*--see subchapter (4), below.)<sup>132</sup> Since this decision was issued it has not

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<sup>128</sup>*Id.*, at 19,804.

<sup>129</sup>*Brown Eng'g Co., Inc.*, NASA BCA 31, 1964 BCA ¶ 4101.

<sup>130</sup>*Id.*, at 20,023.

<sup>131</sup>ASBCA 8481, 1964 BCA ¶ 4091.

<sup>132</sup>Interestingly, when the decision was affirmed on reconsideration less than six months after the original decision was issued, one of the three ASBCA members who had concurred in the original decision withdrew his previous concurrence and withheld it, stating that his subsequent review of the authorities showed that his prior conclusion had been arrived at too hastily, and that under the facts common ownership was "by no means conclusive." *Sanders, Inc., recons.*, ASBCA 8481 1964 BCA ¶ 4375 (Accompanying opinion by George W. Crawford).

appear to have been raised as an issue in any further decisions, apparently having been generally accepted.

## 2. Common Control May be Found in Any Legal Entities.

A second aspect of the common control conundrum, somewhat related to the issue previously discussed, is whether the entity or entities having control over a contractor and its lessor need be a single individual or organization, multiple ones, or can be some other entity. The awkward language "between any divisions, subsidiaries, or organization under common control" used in FAR 31.205-36(b)(3) leaves unclear precisely what it is that is meant to be included within its proscription. Once again, the answer has only been reached as the result of repeated disputes and regulatory language changes, and has ended out being very fact-specific.

In *Mauch Laboratories, Inc.*, *supra*, the contractor insisted that the wording of the cost principle then in effect<sup>133</sup> was intended to apply solely to those cases involving common

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Almost a year later the matter was resubmitted to the Board a final time, but Mr. Crawford had been replaced on the Board and the previous decisions were affirmed without discussion of this point. *Sanders, Inc., resubmission*, ASBCA 8481, 65-2 BCA ¶ 4942.

<sup>133</sup>See note 125, *supra*. It should be noted that although it has remained substantially similar, the cost principle has since been revised slightly as to this aspect, essentially replacing the word "plant" with "subsidiary." That this has not resolved any of the interpretational conflict is understandable.

control by an organization, as opposed to common control by a parent individual. Rejecting that interpretation, the ASBCA stated that such “would require an implied reading of the words ‘by parent organizations,’ or an equivalent thereof, after the words ‘common control’ appearing in the ASPR provision.”<sup>134</sup> The Board opined that such “interpolation” of its meaning would nullify the purpose and intent underlying the cost principle, which the Board stated to be was that the common control be “of any legal entity, be it individual or organizational.”<sup>135</sup>

*Mauch Laboratories* was cited as authority for that proposition in *Starks Contracting Company, Inc.*,<sup>136</sup> reaffirming that an individual may be the common owner. There, the contractor’s president personally owned the land, offices and warehouse to which the contractor paid rent. Stating that the contractor failed to demonstrate otherwise, the Veterans Administration Board determined that it was proper for the Government to have disallowed the amount of rental costs which exceeded those of normal ownership.<sup>137</sup>

The holding in the appeal of *Manlabs, Incorporated*,<sup>138</sup> established that common control can exist in the situation where a husband and wife wholly own and operate the contractor corporation, even though each owned only 50% of its stock, where they are also the exclusive beneficiaries of a trust which owns the facilities leased by that corporation.

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<sup>134</sup>*Mauch Laboratories, supra*, at 19,803.

<sup>135</sup>*Id.*, at 19,803.

<sup>136</sup>VA BCA 1339, 79-2 BCA ¶ 14, 018.

<sup>137</sup>*Id.*, at 68,852.

<sup>138</sup>ASBCA 12389, 69-1 BCA ¶ 7480.



There, despite a number of transactions which were variously described by the Board as "sham" or "for record purposes," the Board found that a Mr. Kulin and his wife commonly controlled both the contractor corporation as well as the trust which had been exclusively funded by them, and in whom was held the exclusive power to appoint and to remove the trustees.

The contractor had argued, *inter alia*, that neither the husband nor the wife was in control of the trust, because each held only 50% of its outstanding shares. Holding "it is hardly a novel observation that...it may be assumed that those who are married to each other and who make investments in the same enterprises will act in unison and harmony in furthering their mutual economic interests," the Board looked to the substance of the various transactions, rather than their form.<sup>139</sup>

Decisions have thus established that common control may be held either in a single or several natural persons, or in an artificial one, such as a corporation. Further, the entity over which that control is held at the least can be an individual, a company incorporated or not, or a trust.

### 3. Control Isn't Determined Strictly By the Numbers or Percentages.

In *A. S. Thomas, supra*, the ASBCA found no common control, even though the

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<sup>139</sup>*Id.*, at 34,704.

contractor's founder, who served as both corporate president and treasurer and 91% shareholder, was also the largest single shareholder of its corporate landlord, holding 34% of its stock and for which he was a director and served as treasurer. This latter corporation, which owned the facility leased by the contractor, had been founded and was managed by A. S. Thomas's brother, a 34% shareholder in the landlord corporation, who simultaneously served as clerk and general counsel for the contractor. Together, the brothers owned a majority of the stock of both corporations.

Nevertheless, the Board observed that no single person or organization held a majority financial interest in both the landlord and the tenant, and that "there was no control in fact by either brother over the other, by either corporation over the other, or by any outside source over both brothers or both corporations."<sup>140</sup> Accordingly, it stated that "[w]e do not believe the language of the clause reaches a minority financial interest such as has been established here."<sup>141</sup> The Board thus determined that there was no common control, although implicitly holding that the common control could exist where a contractor and its landlord corporation have as their majority stockholders persons who are related and who manage them, even though those individuals do not reside together in the same household.

On the other hand, *Manlabs, supra*, demonstrates that common control can exist under circumstances where no entity controlling the landlord holds more than half of the ownership in the contractor. Further, the Board's holding in *Isaac Degenars Company*<sup>142</sup>

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<sup>140</sup> *A. S. Thomas, Inc., supra*, at 25,495.

<sup>141</sup> *Id.*, at 25,495.

<sup>142</sup> ASBCA 11045, 11083, 72-2 BCA ¶ 9764.

expressly limited *A.S. Thomas* to its specific facts, providing that its factual circumstances “directly negated any actual control.”<sup>143</sup> In *Isaac Degenars*, common control was deemed to have been established where a contractor’s manager effectively controlled the entities which owned the equipment it had leased, those entities being his wife and the estate of his deceased sister.<sup>144</sup> In other words, the contractor’s manager was shown to have been in control notwithstanding that he had no ownership interest in the equipment lessors in his own name. Finally, *Talley Defense Systems, supra*, makes it clear that ownership percentages and commonality are irrelevant, holding that the determinative factor is whether the entities acted as though intending to achieve a common goal.<sup>145</sup>

Once again, whether or not control exists will depend on the specific facts. Control can be found where there is no legal unity between a contractor and its lessor, where a common owner holds a 50% interest, or where there is a complete unity of ownership; on the other hand, the existence of common control can be defeated even where a person holds more than 50% interest. Cases reveal that there is no hard and fast rule basing the finding on numbers or ownership percentages alone.

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<sup>143</sup>*Id.*, at 45,622.

<sup>144</sup>Actually, the common control determination in this case was reached for purposes of determining the proper equipment rental rates to apply in relation to a subcontractor’s rental costs under a constructive change, rather than in interpreting the instant cost principle (as the other decisions have done). See note 107, *supra*. Whether the holding in *Isaac Degenars* of common control is appropriate authority for limiting the cost allowability under the cost principle is questionable.

<sup>145</sup>*Talley Defense Systems, supra*, at 127,157.

#### 4. Familial Relationships Do Not Necessarily Establish Common Control.

Analysis of the cases previously cited further shows that family relationship likewise is not necessarily determinative when deciding whether a contractor and its lessor are under common control. Neither marriage, blood relationship, nor parentage, without more, establishes common control necessary to trigger the limitation, although depending on the specific circumstances such might.<sup>146</sup> The boards and courts will look to the actual control itself, and how or whether it is exercised. While the existence of some type of blood or personal relationship might be a factor sufficient to call into question whether there is common control, it is not conclusive. Again it will be the facts that govern, and whether there is control will depend on whether the actions of the entities exhibit that control.

#### C. CONCLUSION

The common control restriction applies whether a contractor controls the entity which

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<sup>146</sup>See *Manlabs*, *A.S. Thomas*, and *Isaac Degenaars*, respectively.

owns the property it is leasing, the contractor is controlled by the lessor, or both of them are commonly controlled by some other entity. Control over the entities' management or policies is the critical focus, and such control will be deemed to have been established where the specific facts and circumstances show that the contractor and its lessor have acted in concert to further some common goal. There are no set indicators of common control, but must be a determination based on the specific facts and actions of the entities involved.

The stated intent underlying the cost principles is accomplished if the Government is protected against paying out amounts which result in duplication of costs or pyramiding of profits being paid to the contractor and the entity that possesses the control. Nevertheless, this will work to the distinct disadvantage of a contractor who will be reimbursed less of its rental costs than a similarly situated contractor which leases from an entity not under common control. Whether this is "fair" to a corporate contractor that happens to be controlled by its lessor, or *vice versa*, despite scrupulously maintaining its independence in *bona fide* fidelity to its shareholders by acting completely in its own self-interest is not relevant to the determination. Equity wonders if perhaps it shouldn't be made relevant.

## V. OTHER LEASE AND RENTAL COST ISSUES

After this look into the areas of actual and potential misunderstanding and misuse of contractor lease and rental costs, there remain several areas yet to be addressed. Each will be addressed below briefly, but only in detail sufficient to enable working with them in the current context. Attention will be given first to the applicable FAR provisions and other authorities, then it will analyze each as to its intent and how it has been (or should be) interpreted. As with the other matters addressed in this analysis, understanding the reasons for the treatment of the specific costs--why they are, or are not, allowable under given circumstances-- is the key to working with them successfully.

### A. AUTOMATIC DATA PROCESSING EQUIPMENT LEASING COSTS

Allowability of contractor lease costs of automatic data processing equipment ("ADPE") is excluded by express provision from the FAR 31.205-36 cost principle that applies to rental costs generally. The costs of contractor-leased ADPE are instead governed by a cost principle specifically limited to such category of costs, which can rightly be characterized as unnecessarily complicated. The disparate treatment ADPE lease costs receive, through comparison with the treatment accorded other lease costs and why, will be analyzed in the following section.

The applicable cost provision is FAR 31.205-2, which goes into great detail to cover the entire range of treatment and reporting requirements. It provides:

(a) This subsection applies to all contractor-leased automatic data processing equipment (ADPE), as defined in 31.001<sup>147</sup> (except as components of an end item to be delivered to the Government), acquired under operating leases, as defined in Statement of Financial Accounting Standard No. 13 (FAS-13), Accounting for Leases, issued by the Financial Accounting Standards Board. Compliance with 31.205-11(m) requires that ADPE acquired by means of capital leases, as defined in FAS-13, shall be treated as purchased assets; i.e., be capitalized and the capitalized value of such assets be distributed over their useful lives as depreciation charges or over the leased life as amortization charges as appropriate. Allowability of costs related to contractor-owned ADPE is governed by other requirements of this subpart.

(b)(1) If the contractor leases ADPE but cannot demonstrate, on the basis of facts existent at the time of the decision to lease or continue leasing and documented in accordance with paragraph (d) below, that leasing will result in less cost to the Government over the anticipated useful life (see paragraph (c) below), then rental costs are allowable only up to the amount that would be allowed had the contractor purchased the ADPE.

(2) The costs of leasing ADPE are allowable only to the extent that the contractor can annually demonstrate in accordance with paragraph (d) below (whether or not the term of lease is renewed or otherwise extended) that these costs meet the following criteria:

(i) The costs are reasonable and necessary for the conduct of the contractor's business in light of factors such as the contractor's requirements for ADPE, costs of comparable facilities, the various types of leases available, and the terms of the rental agreement.

(ii) The costs do not give rise to a material equity in the facilities (such as an option to renew or purchase at a bargain rental or price other than that normally given to industry at large) but represent

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<sup>147</sup>FAR 31.001 basically defines ADPE as referring to all digital and analog computer components and systems, all peripheral or auxiliary and accessorial equipment supporting their use (connected or not), punched card machines ("PCM's") and systems, and terminal and conversion equipment acquired solely or primarily for use with a system which employs a computer or PCM.

charges only for the current use of the equipment, including incidental service costs such as maintenance, insurance, and applicable taxes.

(iii) The contracting officer's approval was obtained for the leasing arrangement (see subparagraph (d)(3) below) when the total cost of leasing--

(A) The ADPE is to be allocated to one or more Government contracts which require negotiating or determining costs, or

(B) ADPE in a single plant, division, or cost center exceeds \$500,000 a year and 50 percent or more of the total leasing cost is to be allocated to one or more Government contracts which require negotiating or determining costs.

(3) Rental costs under a sale and leaseback arrangement are allowable only up to the amount that would have been allowed had the contractor retained title to the ADPE.

(4) Allowable rental costs of ADPE leased from any division, subsidiary, or organization under a common control are limited to the cost of ownership (excluding interest or other costs unallowable under this subpart 31.2 and including the cost of money (see 31.205-10)). When there is an established practice of leasing the same or similar equipment to unaffiliated lessees, rental costs shall be allowed in accordance with subparagraphs (b)(1) and (2) above, except that the purchase price and costs of ownership shall be determined under 31.205-26(e).<sup>148</sup>

(c)(1) An estimate of the anticipated useful life of the ADPE may represent the application life (utility in a given function), technological life (utility before becoming obsolete in whole or in part), or physical life (utility before wearing out) depending upon the facts and circumstances and the particular facilities involved. Each case must be evaluated individually. In estimating anticipated useful life, the contractor may use the application life if it can be demonstrated that the ADPE has utility only in a given function and the duration of the

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<sup>148</sup>FAR 31.205-26(e) is in the cost principle used to determine allowable materials costs in general. Subparagraph (e) basically provides that the price charged for materials sold or transferred between divisions of a contractor or its affiliates will be at cost, unless the contractor has an established practice of using a price based on catalog or market price, or was competitively determined, and is not unreasonable



function can be determined. Technological life may be used if the contractor can demonstrate that existing ADPE must be replaced because of--

- (i) Specific program objectives or contract requirements that cannot be accomplished with the existing ADPE;

- (ii) Cost reductions that will produce identifiable savings in production or overhead costs;

- (iii) Increase in workload volume that cannot be accomplished efficiently by modifying or augmenting existing ADPE; or

- (iv) Consistent pattern of capacity operation (2 ½ -3 shifts) on existing ADPE.

(2) Technological advances will not justify replacing existing ADPE before the end of its physical life if it will be able to satisfy future requirements or demands.

(3) In estimating the least cost to the Government for useful life, the cumulative costs that would be allowed if the contractor owned the ADPE should be compared with cumulative costs that would be allowed under any of the various types of leasing arrangements available. For the purpose of this comparison, the costs of ADPE exclude interest or other unallowable costs pursuant to this subpart 31.2; they include but are not limited to the costs of operation, maintenance, insurance, depreciation, facilities capital cost of money, rental, and the cost of machine services, as applicable.

(d)(1) Except as provided in paragraph (3) below, the contractor's justification, under paragraph (b) above, of the leasing decisions shall consist of the following supporting data, prepared before acquisition:

- (i) Analysis of use of existing ADPE.

- (ii) Application of the criteria in paragraph (b) above.

- (iii) Specific objectives or requirements, generally in the form of a data system study and specification.

- (iv) Solicitation of proposals, based on the data system specification, from qualified sources.

(v) Proposals received in response to the solicitation and reasons for selecting the equipment chosen and for the decision to lease.

(2) Except as provided in paragraph (3) below, the contractor's annual justification, under paragraph (b)(2) above, of the decision to retain or change existing ADPE capability and the need to continue leasing shall consist of current data as specified in subdivisions (d)(1)(i) through (iii) above.

(3) If the contractor's prospective ADPE lease cost meets the threshold in 31.205-2(b)(2)(iii) above, the contractor shall furnish data supporting the initial decision to lease (see paragraph (b)(1) above). If the total cost of leasing ADPE in a single plant, division, or cost center exceeds \$500,000 per year and 50 percent or more of the total leasing cost is allocated to Government contracts which require negotiating or determining costs, the contractor shall furnish data supporting the annual justification for retaining or changing existing ADPE capability and the need to continue leasing shall also be furnished (see paragraph (b)(2) above).

#### 1. Similarities With Other Lease and Rental Costs Treatment.

The cost principle is similar in many ways to the treatment accorded other contractor lease and rental costs. Like FAR 31.205-36 and 31.205-11, it distinguishes (in subparagraph (a)) between operating and capital leases. It refers to the FAS 13 definitions and provides that if the lease is classified as capital, the transaction shall be treated for cost allowability purposes as though a purchase of the ADPE.<sup>149</sup> Subparagraph (b)(2)(ii) similarly speaks in language clearly derived from FAS 13 capital lease classification criteria, and uses the phrase

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<sup>149</sup>See Chapter II, *supra*, for a detailed discussion of the operating/capital lease distinction as it applies to contractor leases and cost allowability generally; see section C of this Chapter, *infra*, for a discussion of allowable lease costs in general.

“incidental service costs” similarly to the way FAS 13 talks of “executory costs.” Like the treatment accorded other lease costs, subparagraph (b)(3) limits allowable costs in sale-leaseback transactions to those that would have been allowed had the contractor retained title to the property,<sup>150</sup> and subparagraph (b)(4), like the other FAR provisions, limits cost allowability in circumstances where the ADPE was leased from an organization under common control with the contractor. Generally, allowable costs under such circumstances are limited to cost of ownership unless there is an “established practice of leasing similar equipment to unaffiliated lessees,” in which case a greater amount may be allowed.<sup>151</sup> Furthermore, subparagraph (b)(2)(I) sets forth criteria that make allowability contingent on the costs being reasonable and necessary, which criteria are similar to those used for determining allowability of ordinary operating lease costs as well as unexpired lease costs in termination situations.<sup>152</sup>

## 2. Differences in ADPE Lease and Rental Cost Treatment.

Notwithstanding the many similarities in treatment, the ADPE cost principle also

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<sup>150</sup>See Chapter III, *supra*, for a detailed discussion of the sale-leaseback transaction as it applies to contractor lease costs generally.

<sup>151</sup>See Chapter IV, *supra*, for a detailed discussion of the cost allowability treatment generally accorded leases between entities under common control. See also note 148, *supra*, which discusses how the purchase price and ownership costs of ADPE between parties under common control are to be determined under FAR 31.205-26(e).

<sup>152</sup>See Chapter II, *supra*, and V.B, *infra*, for discussions of these topics.

contains some unique provisions or limitations which presently are not found elsewhere in the FAR provisions on lease and rental cost allowability. These differences seem to reflect recognition of the special nature of ADPE equipment and how its useful life will necessarily vary from that of other property, although the treatment accorded these costs likewise appears already significantly dated.

The specific differences in this cost principle include the presence of an annual reporting requirement establishing that the lease is justified, together with supporting data prepared before acquisition by the contractor which addresses certain enumerated criteria,<sup>153</sup> demonstrating on the basis of facts existing at the time of the decision to lease or to continue leasing that leasing will result in the "least cost" to the Government over the anticipated useful life of the property.<sup>154</sup> In order to do so, subparagraph (b)(2) requires that the contractor annually prove such things as the reasonableness and necessity of the costs in light of factors such as those specified, and that the costs represent nothing more than current use charges. Additionally, where the costs meet certain thresholds contained in the cost principle and are being allocated to negotiated Government contracts, there is also an additional allowability requirement that the contracting officer's approval of the leasing arrangement have been obtained.<sup>155</sup>

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<sup>153</sup>See FAR 31.205-2, subparagraphs (b)(1),(2) and (d), respectively.

<sup>154</sup>This "least cost" concept was an allowability test added in 1970 to the ASPR cost principle relating to all rental costs in general, but which was eliminated when FAS 13 was incorporated into the DAR, and later the FAR. For further discussion, see Chapter III, note 171, *supra*, and *LTV Aerospace, supra*.

<sup>155</sup>See FAR 31.205-2(b)(2)(iii).

Unlike the lease and rental cost principles elsewhere in the FAR, there are specific provisions in FAR 31.205-2 to be used in estimating the useful life of ADPE, with a hierarchical precedence generally requiring use of the ADPE's physical life unless the enumerated criteria can be demonstrated.<sup>156</sup> Furthermore, provisions expressly restrict a contractor's ability to replace existing ADPE with newer equipment if it has not yet reached the end of its physical life and it could still be used to satisfy future requirements, and provides guidance as to what cumulative costs may be considered when estimating the least cost to the Government.<sup>157</sup> Such costs generally are all the allowable "life cycle" costs that are needed to operate and to maintain the ADPE.

## B. TERMINATIONS AND LEASE AND RENTAL COSTS

The Government contracts practitioner knows well that whenever the Government determines that it is in its best interests to terminate its contracts for its convenience and elects to exercise that right, it may do so without subjecting itself to breach damages.<sup>158</sup>

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<sup>156</sup>It could be argued that such requirement is an allocation requirement, in that it directs contractors how to assign ADPE costs to cost accounting periods in violation of CAS 409, but such is beyond the scope of this analysis, and will not be addressed further herein.

<sup>157</sup>This raises the same potential defect as raised in the note 156, *supra*.

<sup>158</sup>See the FAR clauses at 52.249-2, 52.249-1, and 52.249-6 which set forth this right contractually, and, *e.g.*, *G.L. Christian & Assocs. v. United States*, 160 Ct.Cl. 1, 312 F.2d 418, *reh. den.* 160 Ct.Cl. 58, 320 F.2d 345, *cert. den.*, 375 U.S. 954 (1963), which generally

Nevertheless, the termination of a contract, whether for the Government's convenience or for default, will result in a contractor incurring a number of increased costs and types of costs which it otherwise would not have incurred. Many of these costs are allowable, including many which relate to unexpired contractor lease and rental agreements that were in effect as of date of the termination.

FAR 31.205-42 is the cost principle which contains the allowability rules for the special costs which are peculiar to termination situations. The provisions of 31.205-42 relating to unexpired leases provide:

(e) *Rental under unexpired leases.* Rental costs under unexpired leases, less the residual value of such leases, are generally allowable when shown to have been reasonably necessary for the performance of the terminated contract, if--

(1) The amount of rental claimed does not exceed the reasonable use value of the property leased for the period of the contract and such further period as may be reasonable; and

(2) The contractor makes all reasonable efforts to terminate, assign, settle, or otherwise reduce the cost of such lease.

(f) *Alterations of leased property.* The cost of alterations and reasonable restorations required by the lease may be allowed when the alterations were necessary for performing the contract.

Analysis of the cost principle reveals that a contractor's rental costs under its unexpired leases, including reasonable costs incurred to restore the leased property to the condition it was in prior to any alterations that were necessarily made for contract performance (where the contractor is contractually required to do so), will generally be

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418, *reh. den.* 160 Ct.Cl. 58, 320 F.2d 345, *cert. den.*, 375 U.S. 954 (1963), which generally provided that the Government had the right to terminate without entitling the contractor to breach damages even in the absence of a provision in the subject contract which so limited the contractor's remedy.

allowed, subject to the following conditions:

- (1) the costs must have been reasonably necessary for the performance of the contract(s) that was or were terminated;
- (2) the claimed rental amount cannot exceed what would constitute the reasonable use value of the property for the period of the contract, together with such further period as may be reasonable under the circumstances;
- (3) the contractor must do what it can to mitigate the costs, including making all reasonable efforts at terminating, assigning or settling the leases; and
- (4) the contractor cost recovery will be reduced by the amount of the residual value of the lease(s) as of the termination.

In order for the practitioner to understand these requirements so as to be able to work with and apply them in a termination situation, each must be analyzed. (As will be discussed below, it turns out that the requirements in some ways overlap or duplicate each other; nevertheless, each must be understood.)

### 1. The Rental Costs Must Be Necessary.

The first requirement is also the most obvious limitation placed on the allowability of rental costs in termination situations. This condition is satisfied so long as the lease was "reasonably necessary" for performing the terminated contracts. In reality, this condition appears to amount to nothing more than a recitation of what is already a "generic" FAR requirement for costs of any nature to be allowable and chargeable to Government

contracts,<sup>159</sup> and it has not been interpreted as giving the Government another opportunity to second-guess the contractor's original decision to lease, but as merely requiring that the leased property have been required under the particular facts for the contract to be performed.<sup>160</sup> Accordingly, this condition seems easily satisfied as long as the leased property meets the general FAR cost allowability requirements that the property rented have been needed for the contractor to perform.

## 2. The Rental Costs Must Be Reasonable.

The condition listed second above is actually more similar to a reasonableness limitation imposed on the amount of unexpired lease costs a contractor will be permitted to charge to the Government. Specifically, the total rental costs claimed may not exceed what would be a fair rental for the property for the period being charged that the contract was performed, as well as any future period which is deemed to be reasonable under the applicable facts.<sup>161</sup> The requirement therefore is two-pronged; the first inquiry must address whether the

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<sup>159</sup>See FAR provisions 31.201-1, 31.201-2, 31.201-3 and 31.201-4.

<sup>160</sup>See, e.g., *American Electric, Inc.*, ASBCA 16635, 76-2 BCA ¶ 12,151, where the Board observed at 58,515 that the condition is met where the leased property was the contractor's plant facility, stating that there was no question that a lease was reasonably necessary, since "without it there would not have been any performance at all."

<sup>161</sup>As discussed in Chapter II with respect to challenging operating lease costs, *supra*, for the Government to establish that a cost is unreasonable is extremely difficult, and under most situations unlikely.



rental rate that is claimed is itself reasonable, and the second must look to whether the amount for the post-termination period for which the contractor seeks reimbursement is reasonable.

Not only does this criterion essentially just continue the same reasonableness requirement, but it even has been interpreted to authorize the contractor increased costs over those it already has charged and for which it previously has been reimbursed. In *Qualex International*,<sup>162</sup> the ASBCA concluded that after a contract had been terminated a reasonable use charge would be allowed for the leased property, even though it was in excess of that which the contractor had charged throughout performance.<sup>163</sup>

The second aspect of this question, which seems to be a corollary of the third condition (discussed below) provides that to be allowable, rental costs for the period after the termination must be reasonable. This determination, then, questions both whether the rental amount claimed is reasonable for the use to which the property is put, as well as whether the length of time the rental continues is reasonable. The former question was addressed tangentially in *Manuel M. Lioudas, Trustee for Argus Industries, Inc.*,<sup>164</sup> wherein it was held that the contractor was entitled to payment of only what the Board found was a reasonable

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<sup>162</sup>ASBCA 41962, 93-1 BCA ¶ 25,517.

<sup>163</sup>Actually, Judge Burg for the ASBCA opined in *Qualex* at 127,089 that the contractor was entitled to reamortize its lease costs from what it had charged the Government during performance (done on a straight-line basis over the entire anticipated contract performance period, even though the first 11 months were rent-free because the contractor had entered into a long-term lease). After the contract was terminated, the contractor was allowed lease cost reimbursement based on the property's contract monthly rental with additional payment for other benefits the contractor had received by virtue of the longer lease term.

<sup>164</sup>ASBCA 12829, 71-2 BCA ¶ 9015.

use charge for that part of leased property it had occupied after the contract was terminated.<sup>165</sup>

In those cases which have addressed this question, the length of time in which the rental has been allowed to continue and incur further costs has been found to have been reasonable. In *Sunstrand Turbo v. United States*,<sup>166</sup> the Court of Claims, in upholding an "implied" finding by the ASBCA on this point, held at 40,415 that eleven months after the termination date was reasonable under the facts. In *Southland Mfg. Corp.*,<sup>167</sup> 29 months was allowed. It therefore appears that as long as the rental amount charged is not unreasonable (and as long as the contractor is engaged in legitimate post-termination activities), and the time the contractor takes to accomplish those activities is not unreasonable, the second prong of this requirement also will be satisfied.

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<sup>165</sup>The ASBCA deemed that the fair rental of the leased property to the Government was such percentage of the total rental amount as represented the proportional amount of contracts the contractor had with the Government out of its entire contract base when it petitioned for bankruptcy.

See also *American Electric, supra*, at 58,516, where the Board essentially held that the contractor was entitled only to the reasonable use value of the property after termination, by holding that the rental amounts did not exceed the entire property's use value then crediting the Government with the use the contractor put the property to for other work.

<sup>166</sup>182 Ct.Cl. 31, 389 F.2d 406 (1968).

<sup>167</sup>ASBCA 16830, 75-1 BCA ¶ 10,994, *recons. den.*, 75-1 BCA ¶ 11,272. In this case involving a default termination, the contractor was allowed to finish its work in progress. Not until some 29 months after the work was completed was the contractor able to sublet the leased premises, and the Board determined that the contractor was entitled to the rent it paid until that time, even though the property was not being used in the period before it was sublet.

### 3. The Contractor Must Mitigate.

The third condition of allowability for unexpired lease costs in terminated contract situations provided in FAR 31.205-42 essentially requires that the contractor take steps to mitigate its continuing lease costs by attempting "to terminate, assign, settle, or otherwise reduce the cost of such lease." As noted, this is largely a corollary to the second aspect of the requirement discussed above. While the former requires that the post-termination period for which fair rental use is claimed be reasonable in time and rental charged, this condition requires the contractor to make all reasonable efforts to keep lease costs at a minimum.

The decisions on this point are the same ones cited above for the previous proposition, and in each case the contractor was deemed to have acted properly to mitigate. This is not surprising, since determining that the post-termination period and its attendant rental costs are reasonable can likewise be seen to be a determination that the contractor made reasonable effort to mitigate.

However, it is important to understand that merely because a contractor acted within *a reasonable time* to terminate, assign, or settle its lease does not necessarily mean that the Government must reimburse the contractor all its costs to the point of termination, or that the contractor will be relieved of its future obligations to continue to attempt to reduce its costs thereafter. On the contrary, the cost principle's language narrowly seems to require that the contractor take whatever steps may be necessary for it to reduce such cost.

There are no decisions addressing this, but the observation remains valid. The

practitioner representing the contractor must be watchful for failing to mitigate or reduce rental costs adequately by acting in timely fashion and otherwise, and the Government practitioner must take care to see that the contractor is not reimbursed in situations where it has failed to mitigate as it reasonably could and should have done. The matter of mitigation of Government damages should not be overlooked.

#### 4. Allowable Costs Are Reduced by Any Lease Residual Value.

This final requirement, or more accurately limitation, on allowable costs in terminated contract situations provides that the reimbursement will be reduced by the "residual value" of the lease. However, nowhere within the cost principle in particular, or the FAR in general, is that term defined with respect to leases. The concept of an asset's residual value is an accounting idea, generally used to designate what something is worth after it has been depleted or used. By way of analogy to the CAS 409<sup>168</sup> and FAS 13<sup>169</sup> accounting definitions, such would be the value of the lease as of the date it is terminated, assigned or settled.<sup>170</sup> Accordingly, the cost principle provides that the total of the allowable rental costs a

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<sup>168</sup>CAS 409-30 (48 CFR 9904.409-30) defines residual value with respect to tangible assets as the proceeds realized upon the disposition of the asset, providing that it usually is measured by the net proceeds from its sale or its fair value if the asset is traded in on another asset.

<sup>169</sup>FAS 13 is discussed, in detail, in Chapter II, *supra*.

<sup>170</sup>FAS 13 defines in paragraph 5(h) the "estimated residual value of leased property" as its estimated fair value at the end of the lease term (see Chapter II, *supra*).

contractor will be permitted to charge to the Government must be reduced by the extent of the value (if any) of its interest in the unexpired leasehold which it possesses and has by virtue of the termination been forced to terminate, assign or settle.

There are no decisions which have interpreted this provision, so guidance of ordinary legal precedence is lacking. However, since in practice the residual value of a lease as of its termination, assignment, or settlement is essentially how much the lease is worth to the lessee as of the date the lessee must take one of these actions, it appears that under ordinary circumstances there will rarely be any residual value. While it might be possible for circumstances to arise where a leasehold right has value thereafter to the lessee, in practice that would seem to constitute the extreme exception to the ordinary scenario. In essence, then, while the practitioner must be aware of such limitation, the chances of it ever becoming applicable appear to be quite slim. Regardless, the limitation is there, and the practitioner must be aware that it could have an impact.

### C. GENERALLY ALLOWABLE LEASE AND RENTAL COSTS

A final matter which must be clarified concerns what specific elements of cost are allowed under the various potential lease treatments. Unless the practitioner is aware of what specific costs will or will not be allowed in the particular circumstances presented, he or she will not understand how significant the impact of treating a lease as other than a conventional operating lease will be.

As previously noted, lease costs under ordinary operating leases are limited only by the requirements that they be reasonable and not otherwise unallowable under the FAR.<sup>171</sup> As long as the costs charged under a straight operating lease are not greater than the amount that is being charged to lease comparable property under comparable conditions, and are not clearly excessive when compared with other options such as the overall cost of purchasing, all such costs will be ordinarily allowed.<sup>172</sup> A property owner ordinarily would not lease out property unless the lessee "covered" all the costs of ownership together with a profit margin or "return on the lessor's investment" on top of that, so it may be assumed that operating lease rental charges include within them all ownership costs plus profit.

When a lease is classified as "capital" or a contract or FAR provision otherwise restricts allowable costs to "the normal costs of ownership," allowable costs will be limited to those "normal" costs the FAR cost principles say are allowable.<sup>173</sup> This cost of ownership standard is also called the "purchase cost" or "least cost" principle,<sup>174</sup> and can include such cost elements as depreciation, facilities capital cost of money ("FCCM"), and charges for

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<sup>171</sup>See *Engineering Inc.*, NASA BCA 187-2, 88-2 BCA ¶ 20,792, construing a predecessor NASA cost principle substantially similar on this point to the current FAR provisions; See also FAR 31.205-36(b)(1), FAR 31.201-2 and FAR 31.201-3, generally.

<sup>172</sup>One of the few reported decisions where operating lease costs were not allowed in their entirety on a reasonableness basis is *Tutor-Saliba-Parina*, PSBCA 1201, 87-2 BCA ¶ 19,775. There, the claimed costs of renting a crane and forklift were found to be unreasonable because the same equipment could have been rented from the same lessor at a lower weekly rate than the monthly rate the contractor had claimed.

<sup>173</sup>See *Engineering Inc.*, *supra*, at 105,040, where "normal" essentially was interpreted to mean "not deviating from an established norm, rule or principle."

<sup>174</sup>See *Honeywell Inc. v. United States*, 228 Ct.Cl. 591, 593, 661 F.2d 182, 184 (1981).

insurance, taxes and maintenance.<sup>175</sup> Interest on borrowings, such as a real estate mortgage paid by a contractor on facilities it owns, is not allowed under FAR 31.205-20, so that a contractor who rents its facility by way of an operating lease is given an advantage when its rents are reimbursed in full.<sup>176</sup>

Limitations on allowability of lease and rental costs are greater still where a contract provision or cost principle permits the contractor to recover only the costs of ownership of property that *already* has been depreciated and charged to the Government. If the leased property is already fully depreciated, the contractor will be allowed only a reasonable use charge which the Government contracting officer agrees to allow. Such will be based upon consideration of such factors as cost, the property's total estimated useful life, the effect of any increased maintenance charges or decreased efficiency due to age, and the amount the Government previously paid in depreciation.<sup>177</sup> There is no limitation given in the FAR on

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<sup>175</sup>See FAR 31.205-11, FAR 31.205-10, FAR 31.205-19, FAR 31.205-41, and FAR 31.205-24, respectively. In cases where the leased property is not tangible, its fair value will be amortized over an appropriate period, such as the lease term. See, e.g., *Educational Computer Corporation*, ASBCA 20749, 78-1 BCA ¶ 13,111.

As noted in *TDC Management Corporation*, DOTCAB 1802, 91-3 BCA ¶ 24,061 at 120,451, FCCM is the cost of capital or money, and is distinct from the money itself. It is defined in FAR 31.205-10(a) as not being a form of interest on borrowing (which would be disallowed), but rather an imputed cost determined by applying a cost-of-money rate to facilities capital employed in contract performance, irrespective of whether the source is equity or borrowed capital.

<sup>176</sup>See, e.g., *Loral Electronics Corporation*, ASBCA 9174, 66-1 BCA ¶ 5583 at 26,097, *modified on reconsideration*, 66-2 BCA ¶ 5752; *Sanders Associates, Inc.*, ASBCA 8481, 65-2 BCA ¶ 4942 at 23,352. These cases indicate that equality of treatment accorded contractors who own versus those who rent is to be achieved through adjusting the negotiated fee or profit allowance.

<sup>177</sup>See FAR 31.205-11(l), Depreciation, and FAR 31.109, Advance agreements.

the contracting officer's discretion in this regard, so it is conceivable that under some circumstances a contractor could be allowed only a relatively small portion of its rental costs.

In order to avoid the drastic consequences of restricted lease and rental costs allowability under any of these situations, contractor's counsel and staff must remain particularly attuned to situations where the limits are inevitable. Government personnel likewise must be vigilant for instances of contractors who might try to manipulate facts and circumstances to avoid the limitation. If the facts are known and the FAR costs treatment understood, the various allowability standards will bring about the best use of the system as it stands, or refinements so that it can be used properly.



## VI. CONCLUSION

This analysis has revealed a number of key points relating to the category of Government contractor lease and rental costs. The subject is a complex one, and in order to work with and understand it fully the practitioner must rely on many different types of authorities. These include the cost principles, rules and procedures in the FAR, cost accounting standards and other generally accepted accounting principles, and case authority applicable to Government contracts that has developed to interpret the rules. Additionally, an awareness of the issues that frequently arise in this category of costs and how the guidance given to Government practitioners by their authorities directs that they be addressed is also essential to acquiring the knowledge and skills needed to take full advantage of the benefits leasing offers over outright purchase.

Almost any type of property may be leased or rented, and the FAR has provisions which cover all situations. As was observed, some (such as the provisions applicable to ADPE lease and rental costs) are rather onerous to work with and may have become obsolete as technology has progressed faster than the treatment accorded it in the FAR, while others (such as those relating to operating lease costs) are simple and adaptable to the future, being subject only to the reasonableness requirements. However, determining how much of a contractor's lease and rental costs will be allowed under given circumstances requires a full and reasonable analysis, whatever kind of property is involved.

No matter the issue that may arise in any particular situation, how a lease is classified

fundamentally will affect and restrict allowability. These restrictions can cause a contractor to recover from the Government much less than it is actually paying to its lessor, even under a true arms-length agreement. Seeing that this does not occur requires that the contractor attorney or practitioner be aware of the restrictions, to see that they are not applicable to their specific case.

On the other hand, certain facts may be subject to potential manipulation by contractors and their lessors. This analysis has observed a number of ways a contractor could take advantage of and profit from the lease arrangement in ways the FAR and other laws surely do not intend. Regardless of whether this has occurred in the past, preventing it requires that the Government practitioner be aware of how misuse could take place, and remaining vigilant to see that it does not occur in the future.

Nevertheless, even where the rules might permit manipulation, it must be remembered that there is always an overriding reasonableness requirement. If for any reason lease and rental costs may not be limited because they do not fall into one of the categories where allowability is restricted, some part of the costs still may be disallowed as unreasonable in accordance with the factors set out in the cost principles. Unreasonable lease and rental costs must not be permitted.

This analysis has shown that the rules in the FAR which determine the allowability of lease and rental costs are neither arbitrary nor ill-conceived. Instead, they are the result of a detailed process of proposal, analysis, feedback and revision after practical application. Rather than showing that the rules need to be revised or totally rewritten, this analysis has demonstrated that it is the practitioner that needs work. He or she must be educated in order

to work with the cost category. The practitioner will find that with a thorough understanding of the costs there is a logical and rational basis for treating them. Only when the practitioner understands why the costs are treated as they are will the consistent treatment that the Government and the contractors deserve be achieved.

The analysis in the preceding chapters should assist the practitioner in understanding many of the issues frequently encountered with lease and rental costs. As long as everyone is working on the same level playing-field and with the same tools, much of the confusion can be avoided. When that confusion has been cleared up and the parties are able to focus solely on the areas of genuine dispute, working with lease and rental cost allowability will no longer be an oppressive or arbitrary task.